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PROPOSED LEASE OF BOEING 767 TANKERS BY USAF

HEARING

BEFORE THE

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

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SENATE COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

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PROPOSED LEASE OF BOEING 767 TANKERS BY USAF

WEDNESDAY, SEPTEMBER 3, 2003

U.S. SENATE,
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,
Washington, DC.

The Committee met, pursuant to notice, at 2:32 p.m. in Room SR–253, Russell Senate Office Building, Hon. John McCain, Chairman of the Committee, presiding.

OPENING STATEMENT OF HON. JOHN MCCAIN, U.S. SENATOR FROM ARIZONA

The CHAIRMAN. Good afternoon.

In his farewell address in 1961, President Dwight Eisenhower warned of the need to protect democratic processes, stating, “In the councils of government, we must guard against the acquisition of unwarranted influence, whether sought or unsought, by the military industrial complex. The potential for the disastrous rise of misplaced power exists and will persist.” He also cautioned against the folly of living for today and plundering the resources of tomorrow.

While the Air Force’s costly proposal to lease a hundred Boeing refueling tankers cannot be said to endanger the foundations of our democracy, the circumvention of process and reason in this case brings to mind Eisenhower’s admonitions. The question that Congress and the Administration must ask and answer is not whether proceeding with this lease proposal is in Boeing’s best interest, but whether it’s in the best interest of our country.

Months after the tragedy of September 11 oppressed the commercial aircraft market and Boeing lost out on a bid for the joint strike fighter, Congressional appropriators—Congressional appropriators, not authorizers—added a rider to the 2002 defense appropriations bill authorizing the Air Force to lease up to a hundred Boeing 767s for use as aerial refueling tankers, without a hearing. This leasing authority, which ultimately could cost taxpayers tens of billions of dollars, was given to and the acquisition was zealously pursued by the Air Force despite the fact that the military had not previously indicated an urgent need for new tankers.

I want to repeat, the military had not previously indicated an urgent need for new tankers, and leasing the aircraft will cost the American taxpayers billions more than buying them outright.

Just because the Department of Defense was authorized by an appropriations rider to lease the tankers does not mean that it should. But with Congress’ blessing, it is about to. Three of the four Defense committees that are required to approve the lease have already done so. Two of the three committees that approved the multi-billion dollar proposal did so without a hearing. Without a hearing. And none of the three could have reviewed the final lease, since certain clauses in it are still being negotiated.

The Senate Armed Services Committee, which, under the chairmanship of Senator Warner, did not rush through its approval of the lease prior to the August recess, is holding a hearing on the proposal tomorrow morning.

It was reported that, just yesterday, Air Force Secretary Roche said the lease could still collapse if the parties can't resolve two key contract terms. If these terms, which deal with capping Boeing's profit and ensuring that the government receives a good deal on price, are as critical as the Secretary indicates, the Senate Armed Services Committee should not decide whether to approve the lease until all the lease terms and conditions are resolved and made known.

The lack of scrutiny this deal has received until now is extraordinary, particularly at a time when our budget deficit is burgeoning and the extent of our financial obligations in Iraq is just now being understood. The Committees that signed off on the deal did so before hearing from experts, both in and out of Congress, who have assessed this unprecedented transaction.

Just last week, CBO, the Congressional Budget Office, issued a report concluding that the proposed lease simply is not permitted by law and that the additional cost of leasing, as opposed to buying the planes outright, will be considerably more than the Air Force claims.

Yesterday, the Department of Defense Inspector General opined that only should a formal AOA analysis of alternatives have been conducted, but also that leasing the aircraft and then returning them to the special-purpose entity appears to be an inefficient use of money. In addition, he questioned why the Air Force did not acquire fewer planes until the fundings obtained through the budget process to purchase the aircraft and it can be shown that the tanker meets warfighter requirements, and noted that the Federal Government assumes greater financial risk with a lease than a procurement.

The Congressional Research Service and the General Accounting Office also have raised serious questions about this transaction. CRS has, among other issues, examined the controversial question of the alleged "urgent need" for these tankers. GAO has also expressed concerns with claims about the "urgent need" to recapitalize the tanker fleet, the total cost of the program, and to the extent to which the proposal complies with the law.

An editorial in the Wall Street Journal this morning suggested that there was a consensus on the urgent need to replace the current tankers. The editors are apparently unaware that the Air Force and Boeing found no such need in a study they conducted last year. In addition to CRS, the DOD Inspector General, and GAO, officials at OMB, and many other experts also have questioned the urgency of the tanker replacement, suggesting that the tanker fleet is in good condition and can perform its mission until it can be replaced over time in the most cost-effective way. It would have helped this Committee and the American taxpayers if a thorough study and analysis had been made, which, to this day, it has not.

A number of taxpayer and public interest groups also have raised questions with the proposed lease, with perhaps the strongest statement in opposition coming from the Nonpartisan Citizens Against Government Waste, who today issued a press release characterizing the lease as, quote, "expensive unnecessary budget-busting, scandalous, and the worse example of corporate welfare and backroom dealmaking in recent memory."

In addition to receiving information from others who have examined the proposal, the Committee undertook its own inquiry into the process by which this lease was developed. The story that is told by the documents provided voluntarily to the Committee by Boeing, and, to a much more limited extent, by the DOD and OMB, is one of extremely aggressive sales pitch, not only by a company whose mission is to protect its shareholders and to make profitable deals, but by the United States Air Force, whose mission is very different.

From the beginning, the Air Force appeared not so much to negotiate with Boeing as to advocate for it, to the point of appearing to allow the company too much control, not only over pricing and the terms and conditions of the contract, but perhaps also over the aircraft's capabilities.

I might add there is a news media report today that there is a inquiry of criminal behavior on the part of a member of DOD at that time, who now works for Boeing.

The documents obtained provide a troubling view of the extent to which the company, and not the military, controlled this acquisition. They do not answer, however, why Congress bypassed the normal review process and authorized, nor why the DOD, OMB, and the White House signed off on, an extraordinarily costly method of acquiring planes from a single source without ever clearly establishing the need for them or conducting an analysis of alternatives. I know of no time in history when an analysis of alternatives was not conducted.

Certainly serious concerns with the cost of the lease and its compliance with leasing criteria were raised by officials within the Department of Defense and OMB. Even after the Air Force announced, in May of this year, that DOD had approved the lease, the Department's Office of Program Analysis and Evaluation, which provides independent analytic advice to the Secretary of Defense, opined that the proposal did not meet legal requirements.

Last year, before the budget deficit ballooned and before we incurred the obligation to reconstruct Iraq, then-director of OMB, Mitch Daniels, wrote to me that, "I believe it would be inconsistent with OMB's circulars and 3 irresponsible to support any lease proposal which would cost taxpayers more than direct purchase." Yet even the Air Force's report to Congress, which CBO says seriously understates the difference in cost, admits that leasing the planes and then buying them is more expensive than a direct purchase.

It remains unclear how OMB's concerns about the price of the planes were resolved. We will hear today from a now-analyst hired by the DOD to determine how much the government should pay for the Boeing tankers. This expert concluded that, factoring in a generous profit from the company, the cost of a 767 tanker, with more features than the one we propose to lease, should be $120.7 million. Despite this, the Air Force has apparently agreed that Boeing will get paid $131 million, in 2002 dollars, and subject to cost escalation, for each aircraft, although as a CBO report explains, taxpayers actually will end up paying at least $161 million per plane in lease payments, interest payments, and payments to buy the plane at the end of the lease period.

Although lease proponents claim that taxpayers are being protected both by price concessions demanded and secured by the government and by proposed lease terms that control costs, it is unclear how far these protections go. Price reductions obtained shortly before the lease, was approved by the DOD, seemed to have been accompanied by reductions in aircraft capability and by an implicit promise that the government would acquire at least 200 tankers from Boeing. That we should be acquiring the first 100 by circumventing the authorizing process in Congress and a meaningful analysis of alternatives by the military is troubling enough. That the Administration would promise to acquire twice as many planes without better justifying the needs for this sole-source contract is mind-boggling.

The value of any concessions on the price of the plane must also be considered against the overall value to Boeing of the lease. An aspect of the lease that until now has received almost no attention is a $5 billion-plus maintenance contract for the new tankers that the Air Force has negotiated with Boeing. Five billion dollars. That represents about 25 percent of the total cost of actually acquiring the tankers, and it appears to have been negotiated as a sole-source contract. Why the Air Force decided not to seek competitive bids for the aircraft maintenance is unclear. Why it agreed to pay $5 billion-plus for a maintenance contract, when Boeing had, in 2001, sent an unsolicited bid to the Air Force offering to maintain tankers for $2 million per plane per year, perhaps a quarter of what the Air Force now has agreed to pay, is unexplained.

Can it be said that the government really got a lower price when the lease proposal covering the acquisition includes an enormous maintenance contract for the seller? The fungibility of Boeing's compensation seems to have been appreciated by the Air Force. And, in one communication, the Air Force wrote to Boeing that while DOD's marching orders were to negotiate a contract not to exceed $131 million, "We can modulate as necessary to make everyone happy while keeping the NTE number intact."

We're all disposed, in these times, to give leeway to claims of military necessity. But the case for urgent need that lease supporters claim justifies this extraordinary transaction simply has not yet been made. The economic case is also wanting. It is considerably more expensive to lease rather than to buy the aircraft. And the CBO stated in its report, "Rather than eliminating difficult budgetary decisions, the lease merely postpones them." This sounds very much like the "living for today and plundering the resources of tomorrow" that President Eisenhower warned us about over 40 years ago. It's not too late to heed that warning.

Senator Inouye?

Senator INOUYE. I'd like to wait until the question period.
The CHAIRMAN. Senator Stevens?
Senator STEVENS. Mr. Chairman—
The CHAIRMAN. I apologize. Senator Fitzgerald was here first. Senator Fitzgerald?
Senator FITZGERALD. Thank you, Mr. Chairman.
Senator STEVENS. Just a minute. I was here before anybody else started. So——
The CHAIRMAN. Were you? Okay.
Senator Stevens?
Senator STEVENS. Long before.
Senator FITZGERALD. I apologize. Senator Stevens may go.
Senator STEVENS. I said hello to Peter as he came in.
The CHAIRMAN. I apologize.
Senator Stevens?

STATEMENT OF HON. TED STEVENS, U.S. SENATOR FROM ALASKA

Senator STEVENS. Mr. Chairman, I'm happy to get a chance to once again try to get the record straight on this matter.

In 1998, I took a trip, as Chairman of the Appropriations Committee. Senator Inouye and I went throughout the Middle East, and we had discussions with a considerable number of pilots. At that time, the pilot list rate was down. It was an extremely difficult period. And we came across, I came across, the concept of the age of this fleet. As a matter of fact, these tankers predate Eisenhower's Administration.

The average age of them is 43 years. There are 544 of them. If we followed the normal period of what we call "recapitalization" and acquired them by buying them one by one, it would take us 70 years to do that. We already have had at least one crash of one of these KC–135s that are in the current fleet, because of corrosion, lost four people on that plane. We also had a situation where, due to the lack of a jack screw—now, a jack screw may not mean anything to many people, but it does to me, because the Alaska Airlines plane that crashed out in California and killed about 40 of my friends from Alaska was found to be the fault of a jack screw. When they found that the jack screws were a questionable item on these planes, they were all—the entire tanker fleet was grounded, and the Air Force had to go out and manufacture 200 new jack screws because they don't make them anymore.

Now, we're both pilots, Mr. Chairman, but I was a cargo pilot, and I view this from an entirely different way you do. I just do not understand why we should put people that fly planes in combat that were made before their grandfathers were in the military.

We have a situation here now that is misunderstood by a lot of people. In 1999, I approached Boeing—they didn't approach me—I asked them would it be possible to put sleeves in the 767s. Some of them may remember that. In Alaska, we put sleeves in old DC–3s and C–46s and fly fuel around our state. I wondered could we put sleeves in the 767s. That looked like it was a pretty difficult proposition, so I urged them to take a look at really trying to find a way to solve this problem. And I pointed out we lease housing, we lease tankers for the Navy, we lease automobiles, we lease almost everything except the White House and the Capitol. Now, when it comes right down to it, this leasing proposition has been a good proposition for business, and, in the long-run, it would be a good proposition for the government.

One of the things that is missed is at least one third of this fleet is grounded at any one time because of maintenance problems. At least one third. Inoperable. Our whole strategy is based upon—air strategy—is based on the refueling capability of our Air Force.

Now, I believe that the difficulty we're having with these planes—and we are having difficulty with them—if one third of them are redlined at any one time—redline: don't fly—then clearly we don't have 544 planes; we have less than 400 that are flyable. And if you talk to some of the people that have been flying over there during this last combat, both in Afghanistan and Iraq, you'll find they all think about the age of this equipment. And it's time, high time, we realized that they have to be replaced. If we let this fleet age any more, we will lose the key to our strategy, as far as the defense of this country is concerned, and that's the refueling capability of our Air Force.

Now, I've seen a lot of things that have come from your office and from some of the people that you've just mentioned about my role in this, and even to commenting about the campaign contributions that I received in 2002, which I did receive and they're reported. This issue started long before that campaign started, and I've been involved in this thing for a long time.

I have pursued the concept of trying to assist and maintain our Air Force as number one. Now, there are other nations of the world that are buying refueling capability; not in the quantities that we maintain them, obviously. Italy, other countries, are buying the refueling capability to refuel by air.

I do believe that there is no question in—there can be no question that the age of these airplanes are an issue. It is "the" issue, as far as I'm concerned.

We have, now, the concept of leasing 100 planes. Those will enable us to retire the oldest of the KC–135E aircraft. The cost avoidance, in maintenance alone, to do so is $5.5 billion. None of that is figured into the figures you mentioned. Neither CBO nor GAO or the Library of Congress took into account the savings from not having to have these planes redlined to the extent that they are now. By the Fiscal Year 2011, these 100 tankers will be delivered. But if we were to buy those 100 tankers under the normal procedures, it would take 30 years to do so.

Now, I concur with the judgment of the Department of Defense with regard to this lease. I challenge anyone about any backroom dealing or anything else. We offered that amendment. It was right in front of God and everybody. It was in the bill when it was reported. It was there to be debated. As a matter of fact, there was some debate about it. And if I understand the Constitution, a law is a law when passed by Congress. There's nothing that says the Appropriations Committee can't find a way to enact a law that's necessary, if it is necessary, and we've done it repeatedly, and often at the request of the Armed Services Committee.

So this is not a jurisdictional fight. It's not a philosophical fight. It basically is a fight over who initiated the concept and whether it's a valid one. I initiated it, and I'm proud to claim it as my own. And I believe that the work that's been done by the Department of Defense and by the OMB has protected the taxpayers' interests and, what's more, will protect the lives of many, many more young men and women who are out there flying these planes day and night. If one time, if just one time, one of those tankers is not supposed to be where it should be in order to refuel a flight of high-performance planes, we'll not only lose the tanker, but we'll lose the planes, too.

Now, it's high time we realized we should—incidently, I fault the Armed Services Committee for not having looked into this before. Why shouldn't they have looked into the concept of how old these planes are? These are the oldest combat planes they're flying today. The oldest. And they should be retired as quickly as possible.

My last comment, as I'm sure my friend from Hawaii will remember, we had a little occasion where we took a flight to Saudi Arabia at the request of the Executive Branch. It required flying all night and being refueled over London. As we were approaching London, we found we're suddenly letting down, going to land. And we did land. And I inquired, "Where was the tanker?" The answer was, "The pilot was pregnant and was having some pains so we couldn't find a replacement pilot in time, so the easiest thing was to bring you down." Well, that was good for us; we were right over London. What if it had been someone else? What if it had been someone else somewhere else who had a problem with a pilot who had to turn around and go back because of the failure of his or her airplane, and not keep the commitments that they had?

Now, I believe, Mr. Chairman, it's going to be a long afternoon. I have to tell you now, I have to go to the White House at 4:30, but I will return as quickly as possible.

But, again, I hope personalities will stay out of this, because I'm frank, and, as I've said, I hope it's plain to everyone that no one from Boeing came to me. I went to them. And it was long before any campaign contributions were made to me for that last election. But, as a matter of fact, if you want to look at it, I think Boeing spent—Boeing employees have been contributing to my campaigns since 1962.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Stevens. I can assure you I have made no comments concerning campaign contributions and—have not and will not. I have known you for many years and know of your integrity.

I would like to submit for the record at this time the DOD document showing the mission capability rates.

[The information referred to follows:]

AIRCRAFT MISSION CAPABLE RATES

AIR FORCE

- KC-135 80%
- KC-10 75%
- E-3 77%
- C-5 61%
- C-141 69%
- B-1 63%
- B-2 39%
- B-52 74%
- F-15E 70%
- F-15C 77%
- F-117 79%
- F-16 75%

NAVY

- S-3B 44%
- E-2C 59%
- SH-60B 57%
- MH-53 59%
- P-3C 58%
- F-14D 66%
- F-14A 68%
- EA-6B 58%
- F/A-18C 69%
- F/A-18E 58%
- F/A-18F 65%

MARINE CORPS

- AH-1W 74%
- AV-8B 67%
- CH-46D 66%
- CH-53E 65%
- F/A-18D 73%

ARMY

- CH-47 80%
- UH-60 81%
- AH-64 85%

GAO - MAY 2002

KC-135 MISSION CAPABLE RATES

ACTIVE: 85%

RESERVE "R" MODEL: 77.9%

NATIONAL GUARD "R" MODEL: 77.8%

RESERVE "E" MODEL: 70.4%

NATIONAL GUARD "E" MODEL: 75.5%

AIR FORCE PROJECTIONS ON REMAINING LIFE OF TANKERS

- LIFETIME FLYING HOURS LIMIT
  - KC-135E = 36,000
  - KC-135R = 39,000
- AS OF 1995 KC-135 FLEET HAD BETWEEN 12,000 - 14,000 FLYING HOURS
  - *ONLY 33% OF LIFE*
- SINCE 1995 AIRCRAFT HAVE AVERAGED ONLY 300 HOURS PER YEAR
- AIR FORCE PROJECTS NO EXISTING KC-135E WILL MEET LIMIT UNTIL 2040
- *WITH ONLY 1/3 OF FLEET'S FLYING HOURS USED, MORE TIME EXISTS FOR A THOROUGH ANALYSIS OF TANKER REPLACEMENT OPTIONS*

The CHAIRMAN. KC–135, 85 percent. KC–10, 75 percent. E–3, 77 percent. C–141, 69 percent. KC–135 has the highest mission capability of any aircraft in the inventory.

Senator STEVENS. Those are the ones that are not in depot.

The CHAIRMAN. This is the—

Senator STEVENS. The ones I mentioned are in depot.

The CHAIRMAN. This is their whole fleet, I would say.

Senator Cantwell?

STATEMENT OF HON. MARIA CANTWELL, U.S. SENATOR FROM WASHINGTON

Senator CANTWELL. Thank you, Mr. Chairman. I appreciate you holding this hearing, and I appreciate the time and attention that you have given to this issue, because clearly the one thing that we want to make sure of is that we do give the attention to the analysis of this proposal and that the public is comfortable that it is in the public interest and is not only in good stead for what the military needs, but is in the best interest of the taxpayers.

Not to get into a debate about when and where the tanker idea first came from, though, I do think it is helpful to go through a few points.

I first became involved in this issue more than two years ago, when I went to visit constituents in my district, the Fairchild Air Force Base in Washington State. It's one of the premier sites and locations for refueling tankers. It was clear to me then, as it is clear now, that we were in need of help on these tankers.

The base was proposing a budget, approved by the Air Force, that showed a huge increase to deal with this problem. And at an average age of over 40 years, the KC–135 planes are the oldest in the Air Force, older than virtually all the commercial aircraft and older than most of the pilots that fly them. And unlike other planes in our military, these planes and their mission cannot be duplicated. As a result, we are dealing with aging planes that need to be replaced.

The KC–135s were originally designed for a 25-year life span. And now they are showing extreme wear and tear. That should be of no surprise to a plane that was supposed to be a 25-year life span. Corrosion and supportability and technical obsolescence are keeping many of these planes out of service and are leading to unreliable tanker fleet.

I think due to the age of the tanker fleet, at one time—there are almost 200 KC–135 tankers, about 20 percent of the fleet, on the ground waiting for maintenance. And currently, these maintenance costs, can average three to four hundred days for each plane. And these maintenance needs will only increase and lead to a decrease in availability.

So how did we get into this situation? And did we ever hear before about tankers before the 2001 legislative session? I would advocate that there was a lot of discussion about tankers prior to that and that this is not a new issue.

First of all, in fact in 1989, the Air Force identified the need for modernization of equipment with a statement of need for KC–135 replacement. Later in 1996, the GAO concluded that the aging KC–135s had led to a skyrocketing increase in maintenance costs and a decrease in availability. The report emphasized that the KC–135s may not satisfy the future requirements. It urged the Air Force to develop a plan to replace the tankers, and it highlighted the KC–135's particular susceptibility to corrosion damage.

It was surprising, but maybe not surprising to others who were here, that also in 1997 the RAND Corporation identified the aging aircraft, and specifically the corrosion issue, as what it called a "crisis on the horizon." And the National Research Council identified seven specific corrosion concerns for the KC–135 tanker. Also, we heard, in 1998, the Air Force Deputy Chief of Staff of Installations and Logistics testify that the KC–135 had extensive structural corrosion and deteriorated electrical wings that went beyond its ability to be fixed.

The Air Force, in 2001, found that the existing fleet, keeping it until 2040, which is something that I think deserves a lot of attention of how and why it was that we thought this fleet could last to 2040, much beyond what we're talking about today, would add an additional $17.8 billion to the life cycle of the planes and that the fleet will experience decreased availability due to the time in depot maintenance.

So our military now depends on the KC–135s for 90 percent of its refueling for Navy, Air Force, and Marine aircraft involved in regional conflicts around the world, not to mention our own increased homeland security issues. And as we look to reshape our military posture by the base closures that we're talking about, we will need to increase our dependence on these tankers to ensure our dominance of the skies.

So we cannot, I believe, Mr. Chairman, ignore the need to modernize the capable tanker fleet and make sure that we are upgrading these in the important time frame that is important to delivering the services that they were meant to do.

Now, we've heard a lot about numbers, and I am sure we're going to spend the next several hours hearing about lots of different prices, lots of different models, and lots of different assumptions, and I doubt, for a second, that any of us will all be on the same model, the same assumptions, and the same prices for any of our discussions. That makes this very challenging.

But I would like to be clear, I think the only reasonable comparison that should be made are the two options of leasing the planes or keeping the status quo. I say that because while some have tried to compare the lease to a purchase, the fact of the matter is that we are in a fiscal situation in which an outright purchase of these aircraft is simply not feasible. Indeed, an outright procurement of 100 tankers would require 140 percent increase in the annual Air Force appropriations. Not only is that impractical, but it would require us to put off other important procurement programs.

We have major systems that Congress and the Air Force have put ahead of the tanker replacement. Now we are in a situation where we're finding out that the need is more dire than maybe we had previously anticipated. The result has been this proposal that is before us today. And that is not to say that any of the Members of this Committee or various other people haven't brought forward this proposal. I'm simply saying, as a Member who went back, prior to my two-year time period here in the Senate, to look at this issue. I found lots of evidence and lots of discussion about the tanker issue.

But is this a cost-effective deal? In considering the cost-effectiveness of this proposal, we must recognize the savings that we'll gain by not keeping on the status quo process, which I think is unacceptable.

If we do not replace these aircraft now, we are facing skyrocketing maintenance and modification costs. For the modifications alone, keeping the old planes will cost the taxpayers over $5 billion to upgrade, not to mention the estimated $17.8 billion in additional maintenance increase attributed to the effects of aging if we keep the status quo proposal.

What are the protections for the taxpayers? In addition to what I think these cost savings are on maintenance, the lease proposal provides good protections for the taxpayers, in that, first, they have gotten the lowest price on the 767 that has been offered in 17 years. It includes an MFN clause that ensures taxpayers will get the best deal offered on this planet anytime in the future. Fourth, it requires an independent audit of this information, and it gives the Air Force the ability to make adjustments or to get out of this platform option if it so chooses.

I believe the tanker lease before is the result of two years of hard work, a lot of discussion. Yes, Mr. Chairman, maybe not enough discussion here in the Senate or—but I know the Armed Services Committee will have its opportunity tomorrow, as well. But I think the American people can be proud that we were able to find a solution that brings substantial cost savings and effective safeguards for the taxpayers. And I am particularly proud that the Air Force has found a solution in an American product.

Boeing has been an industry leader in the tanker market for years, in other points of my chart. And as the gentleman from Alaska has said, the seven-six transport platform has become a solid product. It is being chosen by other countries as a tanker platform. And I don't think that it should be lost on this Committee that the alternative to this product comes from Airbus. Not that I want to get into a large discussion about unfair subsidies that Airbus receives, at this time, but I'm sure that this Committee is going to be discussing a great deal in the future.

However, at this time I do believe that it's important that the American people know that we are giving our fighters, our men and women in the Air Force, a product that we should be proud of and that it will be made by American workers. I think the taxpayers should know that they are getting a good deal at a moment when national security is important to all of us and that we give the men and women the best product and the most cost-effective product that we can give them today.

I do applaud you, Mr. Chairman, for having this hearing. It has given all of us more time to focus on this issue and more time to realize that this is a good deal for the taxpayers and a good deal for national security.

The CHAIRMAN. Thank you.

Senator Fitzgerald?

STATEMENT OF HON. PETER G. FITZGERALD, U.S. SENATOR FROM ILLINOIS

Senator FITZGERALD. Thank you, Mr. Chairman. Thank you for holding this hearing. Mr. Secretary, thank you for being here, and all of our witnesses.

As disparate as the testimonies, thus far, or the opening statements have been, I guess I have to say I agree with parts of all of the statements that have been made. I do agree that there is a need to upgrade the tanker fleet for the United States Air Force. But, on the other hand, I am troubled by how we're going about it. I'm troubled by the so-called lease before us. And there are three points that I'm going to want to ask questions about.

Number one, I have looked—as I understand the transaction, the title to the tankers would be in a trust of which the trustee would be the Air Force. In other words, the Air Force will be the legal title holder to the property. The Air Force would also be the lessee under the lease. In effect, the Air Force would be both the lessor and the lessee. This indicates to me that this arrangement that we have before us is not in, in fact, a lease. If it were a lease, the title to the property would be in the name of a bona fide and independent third party. I think this is actually a sale-and-purchase transaction masquerading as a lease. And I think that's the same conclusion that the Congressional Budget Office came to. And, in fact, there's a handout on my desk—I don't know—I believe it's the CBO who put this out, but they point out that this trust is controlled by the Air Force, and they question the arrangement here.

All of the experts that I have read, on both sides of this, agree that it costs more to do this arrangement than it would to just do a straight-up sale and purchase. I'm wondering if the right thing to do, if there is consensus in Congress that the Air Force does need new tankers, if we shouldn't just do a straightforward acquisition. If it's necessary to cut out some of the red tape in our procurement process—and I'm hesitant to do that, because there are a lot of safeguards in our procurement code, for the taxpayers—but we could probably pass legislation that would make it easy to cut through some of that red tape and do a straight-up purchase and sale.

What is before us here is a complex structured financing transaction that really could have been taken straight out of the Enron playbook. I went through all the documents that Enron submitted to this very Committee a year ago, and I remember talking about all these special-purpose entities and trusts of which Enron was in control. In this case, the Air Force seems to be just using this special-purpose entity in a way that it is very troubling, that obscures the true cost of the tankers, that makes a very—it takes away all transparency to the deal. And from a Congress and a Committee, especially, that roundly condemns similar deals that we saw emanating from Wall Street in the advanced stages of the 1990s bull market, I would be remiss if I were not to comment on that.

So I think the bottom line is here, we ought to have a discussion—why not just buy these tankers, go through the ordinary budget and appropriations process? I understand there's a supplemental appropriations bill, military appropriations bill, coming up to fund the Iraq War. Maybe now is the time to consider this. I don't like us going around doing an end-run around our budget and appropriations process. I think it's a very bad precedent. I agree with the CBO that this is not a true lease.

And I'm also wondering if that isn't why the Air Force has come to Congress in the Congressional Committees asking for approval. I've read the authorization that Congress passed last year, and it does not require the Air Force to come back to any of the four Committees of Congress for approval. You can enter into a lease. Are you coming back and asking to get our seal of approval from Congress because you're concerned it really isn't a lease and it doesn't comply with this? That will be one of the things that I'll want to address.

And, with that, thank you all for being here, and we'll look forward to your testimony.

[The prepared statement of Senator Fitzpatrick follows:]

PREPARED STATEMENT OF HON. PETER G. FITZGERALD, U.S. SENATOR FROM ILLINOIS

Good afternoon. I want to join my colleagues in welcoming the distinguished witnesses who are present today.

I would like to thank Chairman McCain for holding this timely and important hearing on the lease of Boeing Company aerial refueling tankers to the U.S. Air Force.

Our nation's military currently is operating at a heightened level of activity as we continue to engage in the global war on terrorism. As a consequence, it is vital that our armed forces increase their agility and flexibility as necessary to respond quickly and decisively anywhere in the world. Air refueling tankers enable other aircraft to fly farther, stay airborne longer, and carry more weapons, equipment and supplies—both at home and around the world.

The Air Force has stated in its report to Congress that the urgency for these aircraft arises from increased utilization and age of the existing fleet of aerial refueling tankers made up primarily of the KC–135s. The cost to operate the existing fleet has been rising while the fleet's operational availability has decreased due to corrosion, major structural repairs and increased rates of inspection.

I look forward to hearing from our witnesses today regarding three areas of concern to me.

First, the arrangement proposed by the Air Force is not a true lease. Under the arrangement, the owner of the tankers would be a trust of which the Air Force itself, as I understand it, would be the trustee. As trustee of the trust, the Air Force would actually be the legal title holder of the tankers. As the legal owner of this property, the Air Force would in effect be both the lessor and the lessee under the so-called lease. That makes no sense. For this and several other reasons, the Congressional Budget Office determined that the arrangement is in fact a sale and a purchase and that the transactions should be reflected in the Federal budget. If this were a real lease, the legal title holder to the property would be an independent and *bona fide* third party, not the Air Force itself

Second—if the arrangement between the Air Force and Boeing is not a lease but rather a sale and purchase, isn't the arrangement simply a legal construct to circumvent the congressional budget and appropriations process? Congress has roundly condemned the discredited financial practices of Wall Street in the advanced stages of the late 1990s bull market. The arrangement under review today is a complex, byzantine transaction that obscures the true cost of the tankers and reduces the transparency of the arrangement. This legal construct comes straight out of the Enron structured finance playbook.

Most, if not all, parties to and external reviewers of the tanker arrangement agree that it would save the taxpayers money to buy the tankers outright rather than to use the arrangement the Air Force is here proposing. Which leads to my third question, which is what is the public policy rationale in favor of going about this acquisition in one way when we could go about it another way and save hundreds of millions, if not billions of dollars. We're talking about money from the paychecks of millions of Americans. We should treat their money with greater respect in my judgment.

It appears that the better approach is for Congress to take the bull by the horns and exercise its responsibility through the appropriations process. The Congress soon will consider a supplemental appropriations bill for Iraq. Why couldn't this appropriations bill serve as the vehicle to consider and debate the outright purchase of the tankers? If such funding were included in the supplemental, not only would the timing for delivery of the first aircraft be parallel with the proposed lease, but it also could expedite the delivery schedule of the remaining aircraft. If necessary, Congress could consider adding provisions which would reduce the red-tape associated with the government procurement process.

The arrangement that the Air Force has negotiated appears to be the actual sale and purchase of the tankers masquerading as a lease. It looks like we don't have to wait until tomorrow night's NFL opener here in Washington to see electrifying plays. The proposal before us is a naked end run around the budget process. It deserves to be tackled before it crosses the line of scrimmage. We have to play tough defense with taxpayers' dollars—even when military spending is at issue.

Again, I thank the witnesses for appearing today, and I look forward to hearing their testimony. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Lautenberg?

STATEMENT OF HON. FRANK R. LAUTENBERG, U.S. SENATOR FROM NEW JERSEY

Senator LAUTENBERG. Thanks, Mr. Chairman. And I'm sorry to extend this part of the program, but I do have an interest.

And I'm curious about why three Senate Committees are holding hearings this week on the leasing deal with Boeing. It's a huge leasing arrangement, which is open-ended in terms of cost, although some estimate that it could be as large as $26 billion.

And I want to set the record straight. If the Air Force needs this as a critical device for them to perform the valuable service they do, then I think that ought we not to be looking at some of the alternatives, which are to renovate and upgrade the present fleet, which can be done at a considerably less cost.

But I have three primary concerns about this leasing proposal. First, the expense. It's unclear whether they're fully necessary for the military. And I hope that we'll be able to discuss this. The Air Force, like all the other government entities, should be aware of the fact that we don't have enough money to do lots of things that we need to do for—the military included, obviously. It shouldn't throw away any dollars on corporate appetites, especially when the government deficit is so enormous.

Second, I am a strong advocate of open, competitive bidding by private companies before they're awarded contracts or leases by the United States Government. I'm concerned that because of Boeing—and it's a terrific company, done a lot of good service, but the fact is, we have a larger audience to be concerned about than Boeing's immediate needs, and this lease would be given without an independent evaluation of whether it could best meet the Air Force's needs.

And earlier in this session, I was able to pass a bipartisan amendment to the Department of Defense authorization bill that states that DOD has to comply with the competitive contracting laws with any contract awarded for reconstruction activities in Iraq. And, similarly, when one of our largest military suppliers are leasing aircraft to the United States Air Force, I want to know what other companies might have been, if any, for this deal, one of which, if not the largest, commercial lease in U.S. history.

And, thirdly, I've noticed that the Administration has a strong will to privatize federal jobs in first looking toward privatizing the federal air traffic controllers, and now Secretary Rumsfeld is changing the personnel system in the Department of Defense to allow for outside contractors to do typically federal work, although I understand why, in some cases, the private sector is well suited for defense-related jobs. I'm worried about this trend. What does it mean to the effectiveness of the safety and security functions of our Government and its performance, as well as the future interests and the reward for loyalty by our Federal employees? This leasing arrangement for 767s with Boeing will certainly set a precedent, and we ought to have a clear understanding of what significance this precedent has.

So I look forward to hearing from the witnesses about this arrangement, and I reiterate the importance of transparency in all government contracts. And I don't know that anybody feels like we've seen all of the details here that we have to.

And I took an earlier look at a GAO report and saw their estimate of what the difference might be, in terms of an outright purchase, in terms of the savings that we might have. And what is the fondness of this lease arrangement, when it looks like, by any stretch of the imagination, it's going to cost more to do than a—more to deal with than a straight purchase?

So, Mr. Chairman, I look forward to hearing from our witnesses.

The CHAIRMAN. Thank you.

Senator Sununu?

Excuse me. Senator Burns?

Senator BURNS. Pardon?

[Laughter.]

The CHAIRMAN. Senator Burns?

STATEMENT OF HON. CONRAD BURNS, U.S. SENATOR FROM MONTANA

Senator BURNS. Mr. Chairman, in the essence of time, I would submit my statement and listen to the testimony.

The CHAIRMAN. Thank you very much, Senator Burns.

[The prepared statement of Senator Burns follows:]

PREPARED STATEMENT OF HON. CONRAD BURNS, U.S. SENATOR FROM MONTANA

Thank you, Mr. Chairman. I would like to thank all of you for being here today to testify and discuss the Boeing 767 tanker lease proposal.

The men and women of our active, Guard and Reserve components have seen an increased operations tempo (optempo) over the past few years, in particular over the last year or so. This increased optempo does not, however, come without costs. Short lead times for call-ups, coupled with uncertain or lengthy periods of service can make life very difficult on our service members. Increased operations also wear and tear on already aging equipment. Nowhere is this truer than the stress that is being placed on our tanker fleet.

On 23 May 2003, the Department of Defense (DOD) announced they would proceed with the lease of 100 Boeing KC–767A air refueling aircraft. These 767s would replace 120 KC–135E tankers, the oldest of *all* Air Force aircraft, at an average of 43 years. The KC–767 can offload 20 percent more fuel than the KC–135 and can itself be refueled in flight. The Air Force has said that it needs to retire as many as 500 KC–135 tankers during the next decade and plans to retire its KC–135E fleet by 2007. Pentagon officials have said the lease deal would allow the Air Force to begin replacing the aging refueling tanker fleet three years earlier than planned. The Air Force has also said it needs to lease because it does not have enough money in its long-range budget to buy the aircraft as part of its annual budget process.

There is no question that the U.S. Air Force needs more refueling tankers. The importance of these tankers cannot be overstated. Our fighter aircraft and bombers are able to stay in flight and kill their targets only because they can refuel in the air. There is no doubt these tankers are needed. There is also no doubt that the current tanker fleet is in bad shape. Personnel say that the aircraft are difficult to maintain and that parts are hard to find. The Air Force needs tankers now.

Employers, communities and families have been incredibly understanding and supportive of the brave men and women in our volunteer service. However, one can only be supportive and understanding for so long. I cannot—cannot—knowingly and willingly send our military men and women out to protect freedom in equipment that is dangerously aged and deteriorating. I cannot bear to think that because Congress failed to act, needless deaths occurred because the aircraft we made these men and women fly were inadequate and literally falling apart in the sky. Families, friends and communities will not understand this, nor should they. Critics of this lease proposal will talk a lot about cost—and they should, as we should always take cost into careful consideration. However, the cost of unnecessary deaths due to faulty equipment—a problem that could and should be fixed expeditiously—is a cost too high for any of us to incur. I know that many of you are aware of this and are working toward a solution.

Our military has performed nobly in the latest missions with which they have been tasked—the Global War on Terrorism and Operation Iraqi Freedom, just to name a few. The United States military is an extremely skilled, capable force, responding to various missions across this Nation and across the world. They *must* have the tools and equipment to do the job and return home safely.

I pledge to do what I can to make sure that our military has the support they need to get the job done and return home safely.

Again, I thank all of you for being here today. I look forward to the discussion this afternoon. Thank you.

The CHAIRMAN. Senator Sununu?

STATEMENT OF HON. JOHN E. SUNUNU, U.S. SENATOR FROM NEW HAMPSHIRE

Senator SUNUNU. Thank you, Mr. Chairman. I also will submit any formal statement for the record in writing. Thank you very much.

The CHAIRMAN. Without objection.
Senator Brownback?

STATEMENT OF HON. SAM BROWNBACK, U.S. SENATOR FROM KANSAS

Senator BROWNBACK. Thank you, Mr. Chairman. And thank you for your holding the hearing, and thank you for your passionate thoughts on the subject. I always respect the efforts that you put forward on all the issues, and you're a fabulous legislator.

This program is important to the Nation. The Air Force is currently operating with a fleet of struggling refueling aircraft. These flying gas stations are indispensable to today's military. And, unfortunately, the current fleet is old and falling apart. Military pilots in their early 20s are now flying the same aircraft their grandfathers flew, and, of course, that's only if the aircraft are flying at all. Each tanker is grounded nearly one year out of every five for repairs and maintenance. In fact, after seeing these aircraft, Secretary Roche, who's here with us today, called their condition, quote, "scary." I share the Secretary's concerns.

The current fleet of the KC–135s is an aging fleet, estimated to cost the Air Force more than $5 billion in maintenance and repair cost over the next 15 years. The fleet is in such bad condition, it is estimated that 40 percent of the aging tanker fleet is unavailable on any given day because of maintenance and repairs. By stalling this deal, we're stalling the safety of our nation's service men and women who operated these tankers.

This deal is not only important to the Nation, it's important to my state, of Kansas. Since September 11, Kansas has suffered tremendous layoffs in the aviation manufacturing sector. This deal would bring much-needed work to the state of Kansas, where Boeing has a large presence. And I realize that's a selfish interest to Kansas, but it's certainly an important one to me in my state. It's estimated that this 767 tanker lease program can result in more than 1,350 direct jobs and 3,100 multiplier jobs. Wichita was one of the hardest hit communities from September 11. And to stall this deal only means stalling much-needed help into that community.

And I have a chart I just want to show to remind some of the Committee Members. After September 11, one of the leading businesses hit in this country was the aviation manufacturing sector. That was one of the most direct hits after September 11. Boeing, you can see, has lost 27 percent of its jobs—Cessna, Raytheon. That number is actually higher. This chart is based on March figures of the first quarter of this year.

I understand and respect the Chairman for his concern, and particularly for his attention to frivolous use of taxpayer dollars. However, this lease deal is not a case of frivolous spending. I'm sure that throughout today's hearings we will hear about the difference in cost between leasing and purchasing these aircraft.

I'd like to bring to the attention of the Committee an editorial that was published in today's *Wall Street Journal* that the Chairman mentioned that is in favor of the lease arrangement. I think this editorial puts the issue in some perspective.

I want to thank our witnesses for being here today, and I look forward to the discussions that we have on this important long-term arrangement for the U.S. Government.

The CHAIRMAN. Thank you.

I would like to welcome our witnesses, the Honorable James G. Roche, the Secretary of the United States Air Force; the Honorable Douglas Holtz–Eakin, Director of the Congressional Budget Office; Mr. Neal Curtin, Director of Defense Capabilities and Management of the United States General Accounting Office; and Mr. Christopher Bulkcom, a specialist in National Defense at Congressional Research.

I thank all the witnesses for being here, and I appreciate your patience as we proceeded through the opening statements, which were too lengthy, including my own.

I want to thank you, Secretary Roche, for agreeing to appear here today. I know it is not usual practice to appear before a Committee other than the Armed Services or Appropriations Committees, so I thank you for being here today. And please proceed, Secretary Roche.

STATEMENT OF HON. JAMES G. ROCHE, SECRETARY, UNITED STATES AIR FORCE

Secretary ROCHE. Mr. Chairman, thank you very much. I am honored to be here with you today, sir. And thank you, Senator Inouye and Members of the Committee.

It's my honor to testify on our need to begin the modernization of our air refueling fleet in the United States Air Force. The air refueling capability is absolutely vital to our Nation.

As we recently demonstrated in our war on terrorism, the Air Force tanker fleet was a critical force enabler that allowed our coalition force to operate over distant battlefields. In Afghanistan, air refueling made joint operations in a distant landlocked nation possible. In Iraq, our ground forces' overwhelming speed, fire power, and decisive maneuver were enabled by air dominance made possible through thousands of air refueling sorties.

Mr. Chairman, of the roughly 69,000 sorties in Operation Iraqi Freedom to date, roughly 10,000 have been tanker aircraft. Our ability to rapidly project air, land, and sea forces around the globe is critical to our Nation's security strategy and increasingly relies on air-to-air tankers. This dependence and the advance stage of the Nation's air refueling aircraft fleet drive our urgency to recapitalize, as well as the requirement to maintain aircraft available over the United States as part of Operation Noble Eagle.

Today, the on-average 42-plus or 43-year-old KC–135 represents 82 percent of our combat air refueling capacity. The 544 KC–135s on duty today have the oldest average fleet age of any Air Force combat aircraft. And the "E" model, the ones we specifically wish to replace, all 131 one of them, are now 44 years old, on average.

During Iraq Freedom, we restricted the deployment of these aircraft to the European theater to support the air bridge and global power operations due to operation limitations and maintenance concerns. They were unsuited for the high temperatures and short runways in the area of operations, and they had insufficient fuel capacity and less efficient engines. Further, the Air Mobility Command commander was concerned about their reliability. Thus, they were used only between major AMC hubs, where sufficient support was present.

Yet while demand for these assets are increasing, the data show their availability steadily decreasing while the costs to keep them flying are also increasing. Since Operation Desert Storm, mission-capable rates are down 7 percent overall. Program depot maintenance costs tripled, depot work packages doubled, and the depot flow days more than doubled primarily due to the challenges posed by aging aircraft. For instance, Mr. Chairman, 30 percent of all of the hours spent on the aircraft in depot are corrosion-related.

At any given time, roughly one third of the KC–135 tanker fleet is not mission capable, and Senator Stevens is correct, the mission-capable rates of those aircraft not in long-term depot.

The CHAIRMAN. Excuse me. My information, Mr. Secretary, is that currently there are less than 90 KC–135 tanker backlog in the depot out of 545. Is that incorrect?

Secretary ROCHE. Yes, sir. I think that's the backlog. I'm talking about the aircraft mission-capable rates do not include those planes that are in the depot. They are the planes not in the depot. Just as the mission-capable rates that have been discussed, Mr. Chairman, differ between those aircraft that were used in the operation and those that were kept back at home. So, for instance, in the case of the 135E, sir, we only used 36 of the 131 to go forward, and we tried to use our best aircraft. Therefore, you're quite correct, the mission-capable rates of those aircraft were 93 percent. Of their sister airplanes that stayed behind, it was, like, 75 percent, sir.

This is a compelling set of circumstances that motivates us to begin recapitalizing our Nation's force. The principal reason for posing a lease is the advantage it affords for quickly delivering needed tankers to our warfighters without requiring significant upfront funding.

I would be glad to address the questions that were asked earlier, sir, in the course of questions and answers.

We looked at several alternatives to our tanker needs. We evaluated a tanker offering from Airbus, and we took a hard look at re-engineering the KC–135 Echoes. We could put new engines on an old air frame, Mr. Chairman, but still not stem the corrosion and structural challenges we currently face.

Sir, we recognize that this lease will cost marginally more, from a net present value analysis, than a normal procurement program, and we have done this as any corporation would, looking at net present value and taking into account the time flows of monies. But in the Department's view, the immediate long-term benefits, including operational savings, which are not included, greatly offsets the upfront cost of the lease option—or the additional cost, excuse me. We can lease and deliver 100 KC–767 tankers five years sooner than we can under a normal procurement program, yet the net present value of the two alternatives is within $1.5 million per copy, per plane.

To purchase these aircraft on the same schedule, we would need $5 billion in additional funding through Fiscal Year 2006 and more than $11 billion more across future years Defense program. The lease is a unique way of doing business that is not applicable, in my mind, to many other Defense programs. But this proposed contract provides numerous safeguards to protect the government's interests.

In addition to the business considerations that make this approach attractive, there are compelling operational benefits to the KC–767 tanker. It can offload 20 percent more fuel than the 135E it will replace. And unlike the typical KC–135, it can be refueled in flight, thus permitting consolidation of fuel. That's one of the reasons, sir, we can take 131 and replace them easily with 100. The 767 tanker also has the capability to refuel probe-and-boom-equipped aircraft on every mission. And of our operations, our tanker operations in Afghanistan and over Iraq, in each case over 50 percent of our tankings were for non–Air Force aircraft—for Navy, Marine Corps, and coalition aircraft, all of whom use probe-and-drogue.

This aircraft will be able to operate from many more runways than KC–135. It also reconfigures convertible freighter for passengers, cargo, and Med–Evac missions, which will enable it to be part of our overall lift.

Mr. Chairman and Members of the Committee, when the tanker fleet was only 17 years old, the Defense Department—at that time, Secretary Brown, then followed by Secretary Weinberger—was able to capitalize on the investment made by the Douglas Company in the DC–10, the billions of dollars the company had made, and as this program, the DC–10, was ending its commercial life, were able to capitalize on that and acquire 60 KC–10s, tankers. We would like to do the same.

We are delighted, we are blessed that they did that, because the most significant aircraft for refueling our Navy and Marine Corps sister services, as well as coalition aircraft, have been the KC–10. It gave us a chance to exploit an advantage with having a commercial—coming down. It gives us a chance to save money by retiring difficult-to-maintain, expensive-to-maintain "E" models. By leasing, we are able to distribute the costs over a longer period of time and, therefore, not have to disrupt combat capability of other programs. And we get a more efficient and effective system to our warfighters sooner, thus reducing the risk of any class problem that might occur to the class of aircraft.

Thank you, Mr. Chairman.

[The prepared statement of Secretary Roche follows:]

PREPARED STATEMENT OF HON. JAMES G. ROCHE, SECRETARY, UNITED STATES AIR FORCE

Chairman McCain, Senator Hollings and Distinguished Members of the Committee:

Thank you for the opportunity to appear before you today. In light of your busy schedule of such high-profile hearings on the Columbia Accident Investigation, Space Exploration, Internet Taxes, Cloning, and the Hydrogen Fuel Cell Research, it is my honor to appear before a committee with jurisdiction over such cutting edge issues. Today, this committee has called me to testify on a matter that involves not only interstate commerce, but a matter of this Nation's top military priorities—the KC–767A Multi-Year Aircraft Lease Pilot Program. In so doing, I will attempt to clarify the details of the tanker lease proposal that was permitted by Congress nearly two years ago. Since that Act was passed, the Air Force has maintained, and I have testified on record, that there are three hurdles that this proposal must clear before we will conclude any deal. First, the proposal must provide joint and coalition warfighters a long-term solution for our advanced air refueling requirements. Next, any proposal must make logical business sense that capitalizes on current market conditions and practices. And third, the proposal and the vital capabilities it provides this Nation must be advantageous for America's taxpayers. I am proud to be here today to acknowledge that those three hurdles have been cleared.

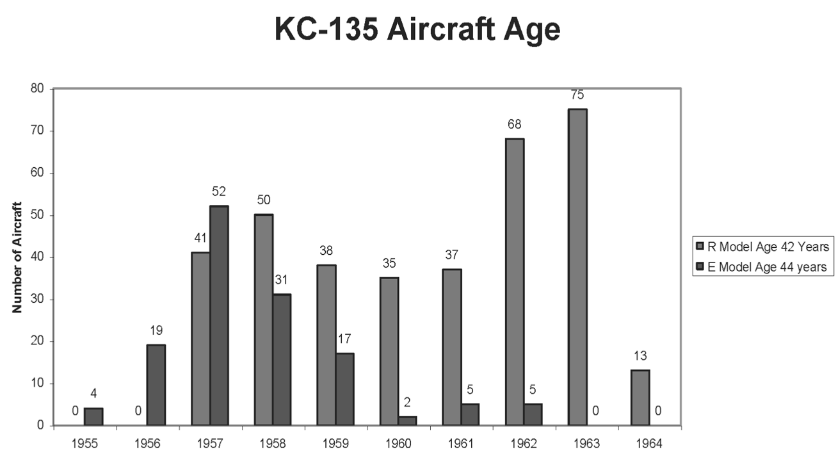
Before I begin, I must commend the men and women who fly, maintain, and deliver the impressive combat capability that is our topic today. Without these incredibly talented uniformed and civilian airmen, this discussion would be irrelevant. These airmen, the heart of our air refueling force, operate everyday all over the globe. From active duty and our Reserve Component units, we draw our vital tanker capabilities from places like Phoenix, Arizona; Hickam Air Force Base, Hawaii; Eielson Air Force Base, Alaska; Forbes Field and McConnell Air Force Base, Kansas; Key Field in Mississippi; Bangor, Maine; Scott Air Force Base, Illinois; Pease Air National Guard Base in New Hampshire; Grand Forks, North Dakota; Beale Air Force Base, California; Tampa, Florida; and Fairchild Air Force in Spokane, Washington.

During the past two years, these airmen and our tanker fleet have been tested hard, flying Operation NOBLE EAGLE (Homeland Defense), Operation ENDURING FREEDOM (Afghanistan), and Operation IRAQI FREEDOM (Iraq). And they delivered far more than could reasonably be expected while operating and maintaining the oldest fleet in the United States Air Force inventory.

Current status of fleet

Tanker dependence in recent wars and the advanced age of the Nation's air refueling aircraft fleet drive the Air Force's urgency to recapitalize as soon as possible. Today, a single 44-year-old aircraft type, the KC–135, supports eighty-two percent of our combat air refueling capability. Beginning manufacture under the Eisenhower administration, 732 KC–135s entered military service between 1957 and 1965. The remaining 544 KC–135s on duty today have the oldest average fleet age of any Air Force combat aircraft, and the "E" model (131) is 44 years old on average. It is the old KC–135Es we seek to replace soonest. The ongoing war on terrorism heightens our concerns regarding these aging aircraft. Our new "steady state" includes tankers supporting fighters defending the homeland as well as the need to maintain the Nation's global reach capability.

Aircraft life can be measured in three ways—usage (flight hours), physical age (years), and utility (usefulness). The KC–135's physical age is the driving need to recapitalize. Through the 1990s, the KC–135 fleet started to show its age. In 1991, Air Force Materiel Command initiated aging aircraft inspections and repairs to maintain the airworthiness of this legacy fleet. By 2000, thirty-two percent of the KC–135 fleet (a significant portion of this Nation's overall Air Force refueling capability) was unavailable due to programmed depot level maintenance as the number and complexity of repairs drastically increased. This reduced the refueling capability to our warfighters and caused a backlog at the depot facilities, as the average number of days in depot-level maintenance peaked at over 400 days.



Annual depot price per aircraft grew significantly as the fleet availability decreased. The combination of increasing costs and decreasing availability projected into the future compels the Air Force to act now to balance cost, capability, and risk; it compels us to begin recapitalization of the KC–135 fleet.

Although General John Jumper, our Chief of Staff, and I have visited the depot at Tinker Air Force Base to investigate the condition of our KC–135s, we do not rely on our observations or anecdotal evidence alone. Independent teams, including teams from Office of the Secretary of Defense, the GAO, and many others, that have visited the KC–135 depot maintenance line at Tinker Air Force Base unanimously recognized the risk that this 44-year-old aircraft could encounter a fleet-grounding event, negatively impacting combat operations across all services and coalition partners.

It should be noted that aircraft corrosion is a significant concern for aging aircraft, both military and civilian. Congress enacted the Aging Aircraft Safety Act, Title IV of Public Law 102–143, in October of 1991 after the in-flight structural damage of a Hawaiian Airlines 737 in April 1988. As you may remember, corrosion had so weakened the fuselage of the aircraft that it burst when it reached altitude and could not sustain the pressure differential between the pressurized cabin and the atmosphere outside. The Federal Aviation Administration has enacted additional rules regarding corrosion and inspections for corrosion since it is of such critical concern for aging aircraft.

The KC–135E fleet—our oldest—is beset with problems that adversely impact its utility to the Air Force, our sister services, and our friends and allies. The planes are operating under flight restrictions pending interim repair of an engine strut—interim repair costs $150 thousand per aircraft, must be complete by September 2004. If the repairs are not made at that time, the unrepaired aircraft must be grounded. The interim repair will only last for five years at which time the permanent repair must be made. Permanent repair of the engine strut would cost $2.9 million per aircraft. If the permanent repairs are not made, the unrepaired aircraft in that case must also be grounded. We are facing a continual set of repairs and maintenance actions that only delay that event. There is also the KC–135 fuel system, which requires repair to deteriorating internal corrosion barriers. Those repairs are estimated to cost $500 thousand per aircraft. Of course, there are always the "unknown unknowns" which become much more prevalent in aging hardware—for example, 40 percent of the KC–135 fleet was non-mission capable from September 1999 to February 2000 as a result of a requirement to replace the horizontal stabilizer trim actuator—an unexpected event that grounded a major portion of our fleet.

Requirement for recapitalization

The cost of continuing to operate the existing KC–135 air refueling force will continue to escalate dramatically. Corrosion, major structural repairs, and an increased rate of inspection are major drivers for increased cost and time spent in depot. More time in the depot directly decreases operational aircraft availability. Operational availability is expected to continue to decrease throughout the remainder of the KC–135's lifespan. Under these conditions of increasing costs and steadily declining availability and performance, combined with the increasing operational demands, actions to replace the KC–135 must begin now.

Our proposal—using commercial airline bodies as tanker platforms—is not without precedent. In the late 1970s, Secretary of Defense Harold Brown began to buy DC–10 aircraft converted into tankers, and Secretary Weinberger continued the program, resulting in the 60 KC–10s that ultimately became our lifeblood. The airplane had been designed and proven successful as a platform, the result of investment by the contractor, not the taxpayer. In hindsight, the success of the KC–10 fleet (59 of 60 are still in the inventory) proves the wisdom of Secretaries Brown and Weinberger's decision to buy commercially developed aircraft, even though the KC–135 fleet at that time was only 16 to 18 years old.

In the case of the KC–135, military aircraft was specially developed for the Air Force. From this model the industry created the commercial carrier, the B–707. These commercial airplanes have been retired for the most part in favor of newer airplanes. In this case, it was the contractor who benefited from the investment made by the Air Force.

You will recall that we capitalized the original 732 KC–135s at a rate of 90 aircraft per year. To recapitalize the 544 that remain at an economical but affordable rate could take more that 30 years. We may already be behind the power curve. We can no longer accept the risk of these venerable aircraft continuing their age-induced death spiral without taking immediate action. A realistic replacement program will take decades to recapitalize a fleet of this size. Even beginning today, some of our KC–135s will pass their 70th birthday before they retire.

Operational need for tankers

We do not propose leasing tankers as a bailout for Boeing or any other aircraft manufacturer. We propose leasing tankers because we need tankers to fight our Nation's wars, and we do not believe we should take the risk to wait for years before we begin.

The Air Force tanker fleet delivered over 375 million pounds of fuel during 30 days of Operation IRAQI FREEDOM, ninety percent of the total fuel delivered by all joint and coalition forces. In addition, our tanker fleet participated in air bridge operations, long-range strike missions, and other global commitments during this time. This great feat allowed Air Force strike aircraft to put relentless pressure on the Iraqi leadership and the Iraqi armed forces. It was the key to 24-hour airborne surveillance. Aerial refueling was the reason that the Air Force could dedicate so many assets to on-call close air support, on-call strikes on time-sensitive targets, and on-call support for our highly successful special operations forces.

But more than just an Air Force asset, our tanker capability enables the combat capabilities that our sister services and coalition partners bring to the fight. For instance, tankers made it possible for Navy and Marine fighters to launch from carriers in the Persian Gulf and strike targets deep inside Iraq. Tankers permitted C–17s to take off from Italy and drop Army paratroopers in northern Iraq. United States Air Force air refueling aircraft delivered over 90 percent of fuel offloaded to our sister services and allies during OIF. On a global scale, General John Handy and his folks at U.S. Transportation Command managed the tanker air bridge throughout these campaigns, simultaneously sustaining our airlift to the theater while our combat forces continued to deter our enemies in the Pacific. Without these vital refuelings, troops and materiel that our Nation needed halfway around the world would have been less effective and slower to respond, jeopardizing our ability to project global land, sea, and air power.

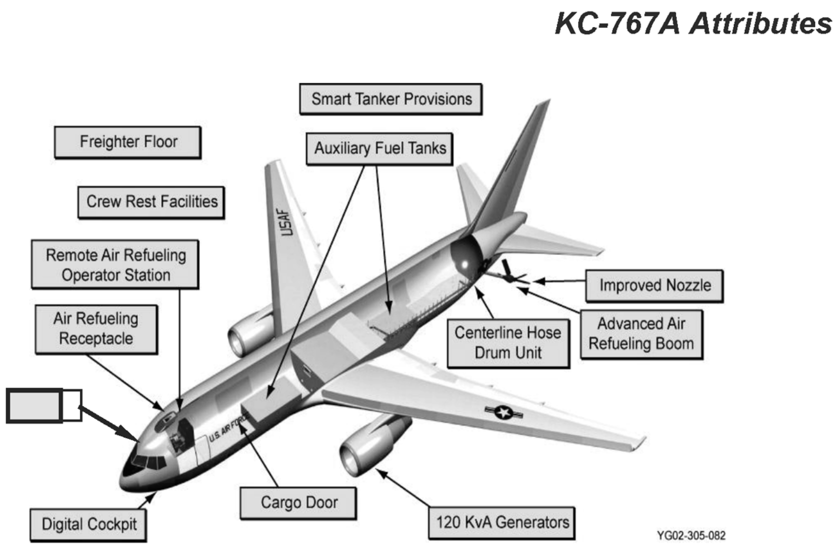
Air refueling tankers enable our entire force to protect our homeland, conduct combat operations, and provide humanitarian relief around the world. They enable other Air Force, Navy, Marine Corps and allied aircraft to fly farther, stay airborne longer, and carry more weapons, equipment, and supplies. As we just experienced in Operation ENDURING FREEDOM and Operation IRAQI FREEDOM, the Air Force tanker was a critical force enabler and force multiplier that allowed our coalition force to operate over a distant battlefield. Air refueling tankers ensure our Nation has the global reach to respond quickly and decisively anywhere in the world. In short, our National Security Strategy is unexecutable without air refueling tankers.

Need/utility of *these* tankers

But again, 90 percent of our current air refueling fleet rests in this single aged weapon system. In fact, the warfighter had to adapt his basing plan to address the limitations of the "E" model of the KC135. During Operation IRAQI FREEDOM, the "E" models were deemed incapable of sustained operations in the AOR due to the high temperatures and shorter runway lengths in theater and the lower fuel capacity and less efficient engines of the "E" model. We found use for them in EUCOM locations during the war, but their support was limited to airbridge, homeland defense, and global power operations. The KC–767A, however, will truly enhance our warfighting flexibility. We will replace 131 KC–135Es with 100 KC–767As, and increase our capabilities.

The KC–767A is a tanker version of the long-range commercial aircraft. This tanker was developed and commercially offered to the international community by the Boeing Company as the Global Tanker Transport Aircraft (GTTA). Italy was the first customer, ordering four aircraft, and has been followed by Japan. The KC–767 tanker will be the world's newest and most advanced tanker. It can offload 20 percent more fuel than the KC–135E, and unlike the E-model, but like the KC–10, can itself be refueled in flight. The KC–767 Tanker also has the capability to refuel probe-and receptacle-equipped aircraft on every mission—an enormous benefit for joint operations. While the KC–767 will have roughly the same maximum fuel offload as the KC–135R, it can takeoff at maximum gross weight in approximately 3500 ft less runway—hence, along with greater operational capabilities, the KC–767A is able to operate from four times as many runways as the KC–135. As delivered, the KC–767A will be configured as a convertible freighter being able to carry all passengers (approximately 200) or all cargo (19 pallets vs. 6 on the KC–135).

It will have a digital cockpit, cargo door, auxiliary fuel tanks, remote air refueling boom operators station, centerline hose drum unit, crew rest facilities, larger 120 kilovolt-Ampere generators, advanced air refueling boom, and aeromedical evacuation capability.



Alternatives considered

In selecting the KC–767A, the Air Force considered a variety of airframes and acquisition strategies. By DOD regulations, the Air Force was not required to conduct an Analysis of Alternatives (AOA) for the KC–767 tanker lease, the reasons for which I will address in more detail later. Even though the Air Force did not complete a formal AOA on the KC–767A, we performed several trade analyses to ensure the KC–767A was the right solution to meet the operational requirements.

Maintain current force structure: The Air Force first considered maintaining the current force structure. The damaging effects of aging quickly became apparent from KC–135 depot work. The unpredictable nature of age-related corrosion—its timing, location, and extent—increases our concern for the risk of an event that would ground the KC–135 fleet. Thus, continuing the status quo was rejected because of unpredictable and potentially calamitous operational mission impacts.

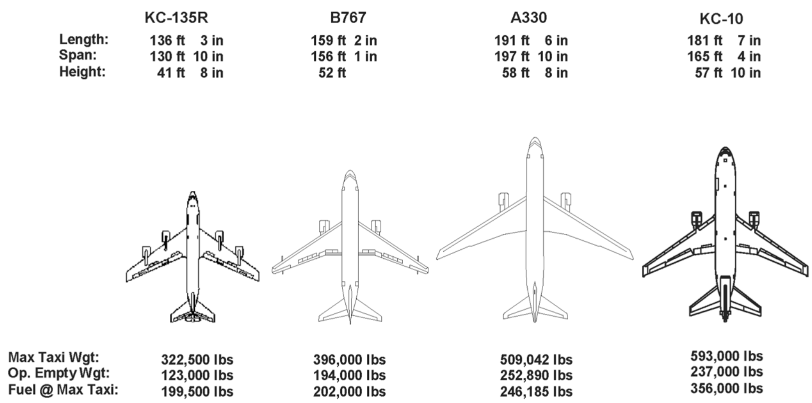
Re-engine: The Air Force also quickly recognized that re-engining the venerable KC–135Es did not address the aging issues, risks to our combat operations, or increasing costs. Re-engining would amount to spending billions of dollars for only a 20 percent improvement over KC–135E capability, but without addressing the “old iron” that needs replacing. Re-engining was not selected as the solution.

Commercial alternative: The Air Force considered acquisition of commercial derivative platforms in tanker configurations. This strategy acquires air refueling tankers derived from commercially available airframes to avoid the high costs of new aircraft research and development. The use of a commercial-based airframe forges synergy with industry in worldwide logistics networks and other support. The question then became: How can we get these mission critical assets to the warfighter in the most expeditious way, at a reasonable cost to taxpayers? Our answer: lease a tanker aircraft that is already commercially available.

In February 2002, the Air Force issued a Request for Information (RFI) to both Boeing and European Aeronautic Defense and Space Company (EADS) to evaluate available technologies and associated risks. Consideration of acquisition of commercially derived platforms included the B757, B767, B777, and the Airbus A330 in tanker configurations, considering both a lease option and a direct purchase. Based on the responses to the RFI, the Boeing 767 was found to be the most favorable. The Boeing 757 was too small to replace KC–135 one-for-one, and would drive additional manpower requirements on a tanker force that is already limited by available crews. The Boeing 777 required almost twice as much ramp space as a KC–135—more than a KC–10—but had a reduced fuel offload capability when compared to the KC–10. Further, the B777 required significant engineering analysis and design work to be modified into a tanker, including the possibility of a shortened fuselage to accommodate a refueling boom during takeoff. The Boeing 767 was selected over

EADS aircraft as a result of its favorable design, schedule, risk factors, and proven boom technology.

AIRCRAFT DIMENSION COMPARISON



To begin the recapitalization of the 544 KC–135 aircraft, the Air Force considered two primary alternatives as acquisition strategies—a traditional procurement of 100 KC–767A aircraft, and an operating lease of commercially derived air refueling tankers in accordance with section 8159 in FY02 legislation. In addition, the Office of the Secretary of Defense Leasing Review Panel considered several alternate procurement approaches in contrast to the lease or planned purchase, including purchases on the same delivery schedule as the lease and applying the funding stream required for a lease to a more traditional purchase program. The Secretary of Defense determined that the lease option best satisfied this Nation's military needs.

The Air Force, with permission from Congress, began negotiations with Boeing for an operating lease of 100 commercially developed KC–767A air refueling tankers. At the time of the FY04 President's Budget submittal, negotiations for the lease were unfinished. Plan A, a KC–X procurement program, was included in the President's FY04 budget, with the program to begin, because of affordability constraints, in FY06. This program in the FY04 PB would deliver one tanker to the warfighter in FY09. The 100th aircraft would be delivered in FY16.

In contrast, under the negotiated lease, the contractor will deliver 60 new tankers to the warfighter by FY09, and deliver all 100 by FY11 which is five years sooner than the FY04 PB procurement program. This plan provides for a quicker start to recapitalization of the tankers. To match such a recapitalization schedule under a purchase option would require billions of additional dollars to be invested during the FYDP as well as waivers of various acquisition rules. Since those funds are already committed to other uses, there would have to be significant restructuring and/or cancellation of ongoing and planned programs.

Business case analysis

Obviously, cost is a big driver when choosing an acquisition strategy. In isolation, a leasing strategy requires additional funds in then-year dollars relative to the cost of a traditional purchase. Economic considerations, however, are not limited to expected funding flows, which ignore the time-value of money. To account for this time-value of money and gain insight into the economic implications of leasing as an acquisition strategy, Office of Management and Budget Circular (OMB) A–94 directs a present value comparison between the proposed lease and a hypothetical purchase based on the same delivery/return profile. The financial analysis for the A–94 test is highly sensitive to the underlying assumptions such as purchase price, expected inflation and appropriate discount rate. Since OMB oversees governmental leases, the A–94 analysis, and the defining requirements for an operating lease, the Air Force consulted them in developing its analytic assumptions. Applying the A–94 test the Air Force determined that the net present value of the multiyear lease option and a traditional purchase option results in an net present value difference favoring a purchase by $150 million—about 1 percent of the total cost. These calculations do not take into account any operational savings which the lease would permit to accrue sooner.

The advantages in schedule and reduced impact to currently budgeted programs outweighed the results of the A–94 analysis and drove the leasing decision. The Air Force and Department of Defense selected leasing as the acquisition strategy primarily based on affordability—by reducing the near-term cost—and minimizing the budgetary impact to our plans for getting accelerated capability of the new weapon system to our frontline troops.

Under the lease option, the Air Force can afford to field this new fleet of tankers at a quicker pace than under a traditional purchase plan. Jumpstarting replacement of the older, less-capable tankers enables faster modernization of air expeditionary forces. The lease not only advances the first delivery by three years, *it puts the 100 aircraft fleet at the disposal of our frontline commanders for combat operations by FY11, five years ahead of the planned purchase.* If we were to purchase these aircraft in a traditional buy on the same delivery schedule, while maintaining our financial top-line, we would have to take billions of dollars out of other important programs.

Implementation plans

Under this Pilot Program, the Air Force intends to lease 100 KC–767A aircraft with Congressional approval of the New Start notification. The lease program will be sole source, using terms and conditions germane to commercial aircraft leases and commercial business practices in accordance with the Federal Acquisition Regulation and section 8159. Terms and conditions of the lease arrangement meet all requirements of the FY02 Defense Appropriations Act including OMB Circular A–11 criteria for an operating lease. Full details of the lease are included in the Report to the Congressional Defense Committees.

This will be a three-party contract between the U.S. Government, Boeing Integrated Defense Systems, and a third-party Trust, the KC–767A USAF Tanker Statutory Trust. The Trust will issue bonds on the commercial market based on the strength of the lease contract with the U.S. Government (rather than the credit worthiness of Boeing), will buy the aircraft from Boeing, and will lease them to the Government. The Trust will not make a profit but will provide for the funds necessary to pay bondholders and pay off the debt after the sale of the aircraft. Any residual funds acquired from the possible sale of the aircraft subsequent to lease termination will be refunded to the Government as an overpayment.

The contract will include "Most Favored Customer" clauses stating that if Boeing sells comparable aircraft (up to 100) during the term of the contract for a lesser price, the Government will receive an equitable adjustment. Besides being a fixed-price contract, and to further guarantee the taxpayers receive a favorable deal, Boeing has agreed to a Return-on-Sales (ROS) cap of 15 percent, whereby in 2011, any ROS in excess of 15 percent in either commercial or military manufacturing centers will be returned to the Government. Again, this is something unprecedented in military acquisitions.

It is not unexpected that new ways of doing business might raise questions or controversies. There have been several questions with respect to this arrangement that I would like to address.

Analysis of alternatives: As stated earlier, the Air Force was not required to conduct an Analysis of Alternatives (AOA) for the KC–767 tanker lease. There is no statutory requirement to conduct an AOA. Regulatory requirements for AOAs are contained in our DoD instruction, *Operation of the Defense Acquisition System,* which provides for their flexible application. Under "Plan A," an AOA was planned to complement the work done under the Tanker Requirements Study and the Economics Service Life Study, to lead to a traditional purchase beginning with the delivery of one aircraft by 2009. However, the operational requirements of the Global War on Terror and the increased demand on the tanker fleet highlighted the need to accelerate the recapitalization of this national asset. "Plan B," this lease program, addressed the critical need the Congress and we saw for jump-starting recapitalization and it made good business sense.

In fact, it is not unusual for a major program to not conduct an AOA. The GAO has previously stated (NSIAD–94–194), "Applicable defense acquisition regulations allow management discretion in these matters for the purpose of minimizing development time and reducing costs." There is additional precedence for not completing an AOA when either the item is a commercial product or there is a low-risk in delivering a product that will be militarily useful. The Air Force did not complete an AOA for the C–130J program since this was an acquisition of a commercial product that had already been marketed to foreign customers—similar to the KC–767A Tanker. No AOAs were conducted for programs such as the KC–10 or the F/A–18 E/F.

Even though the Air Force did not complete a formal AOA on the KC–767A, we performed several trade analyses to ensure the KC–767A was the right solution to the operational requirements. We looked at maintaining the status quo, but we judged the risk too high to not begin the recapitalization effort now as a result of 9/11, increased tanker operations tempo for homeland defense and Operation ENDURING FREEDOM, increased operations and support costs and risks of an aging fleet (catastrophic/grounding event that would significantly erode our ability to meet our mission). We evaluated the feasibility of re-engining KC–135Es, but this does not reduce the aging aircraft risk—we would still have old aircraft that will need to be recapitalized, and the payback of the re-engining cost AND retirement savings [if we were allowed to retire 31 KC–135Es] exceeds 11 years. We researched using "stored" commercial aircraft, but all the aircraft had high hours, different engines, required heavy modifications and there were insufficient numbers of aircraft available to be cost effective. We investigated using a commercial fee-for-service, but while this has been successful in Navy training scenarios, it did not meet our overall operational requirements. We looked at other operational commercial platforms to include an Airbus 330, Boeing 757 and Boeing 777. The Airbus 330 had significant technical risk with integrating boom technology into the aircraft. The B–757 could not carry enough fuel to make it an efficient tanker. The B–777 was too large, reducing the airfields where the aircraft could be deployed. Finally, we researched the feasibility of building a new tanker from the ground up, but this alternative carries a much higher cost and developmental risk, and would not be available within the time-frame the KC–767As would be delivered. The decision to select Boeing was based on Boeing's response to our RFI, including its favorable design, schedule, risk factors, and boom technology.

Why we need tankers so urgently despite the 2001 Economic Service Life Study Report that intimated that the current fleet would last until 2040

Much has been made about the ESLS's prediction that we could operate the current tanker fleet until 2040. What is rarely mentioned is that even the optimistic 2001 Study predicted that Operations and Sustainment (O&S) costs would increase 43 percent by 2040 with 15 percent decrease in availability. The study assumed only 1 percent/year cost growth, but even in as little time as 18 months, that figure was seen as flawed. The updated report raised that figure to 1.5 percent/year. The study was based on statistical calculations, but actual depot sales rates show much greater increases in O&S costs. There have been several studies regarding the aging aircraft.

1995 Fatigue Life Study: Boeing and the C/KC–135 SPO continued their evaluation of the KC–135 expected service life with a fatigue analysis in 1995. This analysis indicated that the KC–135R fleet would not exhibit significant fatigue damage, in the absence of corrosion or widespread fatigue damage, until 70,000 flight hours (66,000 for the KC–135E).

The Air Force and industry debate over the unknown effects of corrosion on fatigue life prompted the C/KC–135 SPO to contract with Boeing to update the fatigue life to include effects of increased stress from corrosion-associated material thinning. Using this combined "net-area" fatigue/corrosion life, the KC–135R service life was adjusted to 39,000 flight hours and the KC–135E life was adjusted to 36,000 hours. Today, the average flight-hour distribution for R models is 16,000–17,000 hours, and 17,000–19,000 hours for the E models. An Air Force/industry "Blue Ribbon Panel" convened in 1996 and acknowledged operation of the fleet out to 2040 is achievable, assuming aggressive corrosion control. Further analysis would conclude that the KC–135 service life is actually limited by age in years, not flight hours.

As early as the Air Mobility Master Plan of 1995, Air Mobility Command (AMC) acknowledged corrosion as a "major factor in the continued service life of the KC–135 forces." At that time, AMC pursued corrosion forecasting technologies and planned on initiating replacement of the KC–135 fleet in FY07 pending verification of the magnitude of the corrosion problem. The 1998 Air Mobility Master Plan again noted that corrosion studies were required with a notional replacement date of FY13. However, as more and more of these inspections took place, it was obvious by 2001, that our reports may have been overly optimistic. In Air Force studies conducted in 2001 we proposed a notional replacement date of FY10.

The depot level maintenance cost growth experienced due to the aggressive maintenance practices implemented with the Aging Aircraft Program caused concern within AMC. The Mobility Master Plan of 2000 called into question the high cost required to maintain the aging KC–135 fleet. The plan states, "The major factor limiting structural life is fleet corrosion. Previous studies did not include corrosion as a significant factor in the service life, nor did they address increased costs and decreased availability that would result from the aggressive maintenance practices required to maintain adequate safety margins." Consequently, previous service life estimates and projected retirement dates may be overly optimistic.

1994–1995 RAND studies: The Air Force contracted RAND to conduct aging aircraft studies based on commercial and military aircraft fleets in order to determine the feasibility of long-term sustainability of the Air Force's aging fleets. RAND completed a series of five studies beginning in 1994 and ending in 1999. These studies raised technical concerns regarding the (1) viability of retaining commercial aircraft past their design lives, (2) viability of retaining Air Force aircraft past their design lives, (3) potential maintenance cost growth associated with aging aircraft, (4) potential engine cost growth, and (5) projection of Air Force fleet-specific Program Depot Maintenance (PDM) and engine cost growth through 2022. The results of the studies concluded that "major support challenges may result from corrosion, insulation cracking, composite delamination, and other material degradation processes for which there are no scientific aging models or relevant historical experience. Most important, many of the challenges associated with aging material have emerged with little or no warning. This raises the concern that a new challenge may suddenly jeopardize an entire fleet's flight safety." The final study recommended a three-pronged strategy for maintaining aging aircraft: (1) risk management strategy to identify age-related hazards that affect cost and safety hazards and develop solutions to reduce their effects, (2) fleet contingency strategy to reduce aircraft design and production lead times of obsolete replacement parts to minimize fleet-wide failures, and (3) mission management strategy to implement acquisition and retirement plans that balance fleet ages within mission areas, making the Air Force less dependent upon a particular fleet of aging aircraft.

The Air Force has implemented two out of three prongs of RAND's strategy for maintaining aging aircraft. The C/KC–135 SPO's Aging Aircraft Program created a risk management strategy by establishing Major Structural Repairs and tracking their repair. The SPO also developed fleet contingency strategies by contracting with new vendors for obsolete parts. The Air Force partially implemented a mission management strategy with the acquisition of the KC–10s; however, 90 percent of the refueling fleet still resides within the KC–135 fleet, creating the potential for fleet-wide system failure. At least partial recapitalization of the KC–135 fleet is needed to satisfy all of RAND's recommendations.

1996 GAO study: The GAO drafted this report in 1996 to validate Air Force actions to preserve its aging tanker fleet and to examine the effects of increased demands on the services' air refueling fleets after Operation DESERT STORM. The study noted that "the Air Force's principal tanker aircraft—the KC–135s—are 30 to 40 years old and, as a result, are taking progressively more time and money to maintain and operate." The results of the study noted, "Air Mobility Command doubts that the KC–135 can be economically operated beyond 2020." This is the result of projected cost-per-flying-hour increases of 24 percent from 1996 to 2001, and historical depot labor hour increases of 36 percent, and depot flow day (aircraft time spent in depot) increases of 55 percent from 1991 to 1995. The study recommends recapitalizing the air refueling fleet with a "dual-use replacement aircraft (that) could fulfill both airlift and air refueling missions."

Negotiated Price

The Air Force negotiated this agreement at the highest levels possible. We employed standard commercial "best" business practices as we negotiated the deal. We firmly believe that the Air Force price is the best price—the best price that can be achieved in the commercial market place in the real world. The difference is primarily one of assumptions. The Air Force treated the tanker lease as a commercial item. The Air Force followed the guidance for buying commercial items contained in Federal Acquisition Regulation (FAR) Part 12. In addition, Section 8159 of the FY02 DoD Appropriations Act specifically authorized the Air Force to use terms and conditions that are customary in non-Government leases. The final price is a product of a careful analysis and market research by the Air Force and extensive price negotiations with the contractor. We believe the Air Force has received a fair and reasonable price under the lease. However, we are not relying solely on our price analysis. The lease agreement contains most favored customer provisions and a 15 percent limitation on the contractor's total return on sale for the tankers. In addition, the contractor bears the risk of delivering conforming aircraft at a fixed price.

Also, the aircraft price must be viewed in a larger context. The aircraft must meet the performance specifications stated in the contract and must have a high [80 percent] operational availability rate. The contractor must maintain the aircraft to the specifications and the high (80 percent) availability rate throughout the term of the lease.

In contrast, the study conducted by IDA used a different basis of estimate; they looked at the manufacturing process used, associated development costs, risk management, and contract type. Nonetheless, the Air Force capitalized on much of the additional information derived through the review by the Office of the Secretary of Defense in our final negotiations.

Programmed retirements

Our plan to retire 68 KC–135Es in FY04 will increase fleet utilization by freeing money and personnel that would be required for maintaining KC–135Es that could be used on KC–135Rs. This is true even if we do not lease the 767. This retirement of 13 percent of the fleet would result in only 4 to 5 percent decrease in average sortie generation. If we only retire 12 aircraft in FY04 versus going with the original 68-reduction plan, we would need approximately $40M FY04 dollars to cover the additional costs of keeping the E's around. This is based on three additional Programmed Depot Maintenance requirements at approx $8M a piece and thirteen additional engine overhaul requirements at $962K a piece. Additionally, we will need to replace $75M in funds offset in FY04 to divest 44 tankers. This includes flying hours and military personnel costs. The total bill in summary: added DPEM costs plus FY04 offset, $40M + $75M = $115M. The "retire 12 in FY04" plan has no monetary impact on the "68-reduction" plan in FY05 and FY06, assuming that we use FY05 to "catch up" on aircraft retirements, but may require some operational workaround to account for the rapid retirement.

Conclusion

I want to thank the Committee for allowing the Air Force to share its concerns about the need for a new tanker. I believe the KC–767A Multi-Year Aircraft Lease Pilot Program offers us the opportunity to jumpstart recapitalization of our aging KC–135 tankers. Recent events and increased requirements to support homeland defense have spotlighted our reliance on these critical refueling assets. Tanker dependence in recent wars and the advanced age of the Nation's air refueling aircraft fleet drive the Air Force's urgency to begin recapitalization as soon as possible. The negotiated lease proposal would provide for the delivery of 60 aircraft within the FYDP and field the 100th aircraft by 2011, five years faster than current purchase plans. This minimizes near-term budgetary impact to other important programs.

I fully support this leasing alternative to provide the warfighters with new equipment as quickly as possible. This leasing program supports the Air Force's essential mission requirements that support the defense of America.

I appreciate the support provided by Congress and look forward to answering any questions this Committee has about best satisfying our warfighter needs in the future. Thank you for the opportunity to provide this statement for the record.

The CHAIRMAN. Thank you.

Mr. Holtz-Eakin, welcome.

STATEMENT OF HON. DOUGLAS HOLTZ-EAKIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. HOLTZ-EAKIN. Mr. Chairman, Senator Inouye, Members of the Committee, thank you for the chance to be here today.

At the request of Senator Nickles, CBO has analyzed the tanker lease financing plan, and I submit our report on that plan as my written testimony.

In my time, let me touch briefly on three main points in that report, and then allow time for questions, as your interest indicates.

The first point, which is illustrated in the diagram pointed out by Senator Fitzgerald in his opening remarks, is that purchases and the debt of the special-purpose entity, the tanker trust, should be considered Federal spending and borrowing. The trust exists solely for the purpose of purchasing these assets, and does so by borrowing money in order to finance that. And in the process of conducting those operations, the actions of the trust will be entirely controlled by the Air Force. For this reason, only those flows of money from the trust to the Boeing Corporation for purchase of the aircraft or from the trust to the credit markets in the form of construction financing or interest on bonds should be recorded on the federal budget. The remainder of the transactions between the Air Force and the trust, for example, should be treated as intergovernmental and not register on the budget.

The CHAIRMAN. And how much is that?

Mr. HOLTZ-EAKIN. The flows to the Boeing Company will be on the average of $131 million per plane. And the total cost to the Air Force into the trust for purchases plus leasing, this is 162 million, the different represents the cost of the financing plan underneath this particular arrangement.

But our view is that this particular trust should be viewed as part of the government. It exists to purchase these planes, and its spending should be considered federal spending. Its borrowing should be considered federal borrowing.

The CHAIRMAN. About $30 million per aircraft.

Mr. HOLTZ-EAKIN. Yes.

The CHAIRMAN. Thank you.

Mr. HOLTZ-EAKIN. The second point covered in the report is that if one were to set aside the issue of whether the trust is, in fact, a part of the government and look at this leasing arrangement as a lease, it does not satisfy the requirements to be treated as an operating lease in which the budgetary presentation would show very few entries up front and be heavily back-loaded, but instead should be treated as a lease-purchase with an entry up front as the agreement to lease and then purchase that's entered into, changing the stream of budgetary flows as presented to the Congress. This is reflected in the first table that's included in my handout, which shows the difference between tanker financing as a lease-purchase, in the top panel, versus as an operating lease, in the middle panel.

As the Members of this Committee are probably aware, there's a six-part test that one subjects a lease to in order to determine whether it's appropriate to treat it as an operating lease. The elements of that test are whether what is at hand is a general-purpose asset, whether there is a private-sector market for this asset, whether the lease payments constitute more than 90 percent of the purchase—of the value of the asset, whether the lease contains a bargain purchase price as part of its arrangements, whether the lessor retains ownership of the asset, and whether the term of the lease is less than 75 percent of the asset life.

Detailed in our report, we believe that scrutiny of this particular arrangement fails the test as an operating lease. And while we could go through on a point-by-point basis and examine the applicability of the criteria for an operating lease, I believe that the overall tenor of the arrangement is at odds with the spirit of an operating lease, and that even a close scrutiny of bright-line accounting-style tests would fail, and the spirit would fail, as well.

The third main point in our report is that this approach to financing the purchase of these aircraft is more expensive than the traditional appropriations approach. Indeed, the bottom panel of the table, which is included in the handouts, compares the direct purchase of tankers. This would be the same 100 airplanes, on exactly the same schedules. And if one were to do this via the appropriations process, Boeing would continue to receive the same $131 million for each aircraft, and the Air Force would, in fact—and the government pay them that much; however, over the life of the plan, from 2004 to 2017, the difference in the budgetary cost would be $5.7 billion cheaper in direct purchases. Or if one were to do a present value comparison, if one were to conduct the imaginary experiment, "How much would we have to set aside today in an account to honor the commitment to buy 100 aircraft?" one would have to set aside $13.6 billion for direct purchases; whereas, one would have to set aside $14.9 billion to do this via the leasing arrangement, as proposed in the Air Force report. That difference, $1.3 billion, could be as large as $2 billion. It represents the extra cost of undertaking the purchases via an inefficient financing mechanism.

And, in closing, I would point out that—

The CHAIRMAN. Could I—

Mr. HOLTZ-EAKIN. Certainly.

The CHAIRMAN.—ask you? You've got $21.5 billion if it's under financing plan as a lease-purchase or as an operating lease, and then $15.9 billion if it were direct purchase. I see that as a five-point-——

Mr. HOLTZ-EAKIN. Six.

The CHAIRMAN.—six-billion dollar difference.

Mr. HOLTZ-EAKIN. The difference is due to rounding. If one goes out more decimals, the difference would be $5.7 billion.

The CHAIRMAN. $5.7 billion difference between a direct purchase under the same schedule that the leasing is taking place, only with the $5.7 billion difference to the taxpayers.

Mr. HOLTZ-EAKIN. That's correct.

The CHAIRMAN. Thank you.

Mr. HOLTZ-EAKIN. In closing, what is woven through these three points about in our report is that in each case the financing treatment transforms what is apparently a stream of budget authority and outlays needed in order to purchase these planes from being, to some extent, frontloaded to being more backloaded. In that process, undertaking purchases in this way undercuts the standard authorization appropriation process by placing some projects on an uneven advantage, versus others, in the competition for budgetary dollars. By placing these purchases on a level playing field, they can compete in a way that will reflect merely the priorities from a policy process and not the advantage that's gained by a special financing.

I'd be happy to take your questions.

[The prepared statement of Mr. Holtz-Eakin follows:]

PREPARED STATEMENT OF HON. DOUGLAS HOLTZ-EAKIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Assessment of the Air Force's Plan to Acquire 100 Boeing Tanker Aircraft

CONTENTS

Summary

The Department of Defense Appropriations Act, 2002 (Public Law 107–117), authorized the Air Force to pursue a pilot program for leasing as many as 100 Boeing 767 aircraft for up to 10 years and directed the service to describe its plan to the Congress before entering into such a lease. The Air Force, Boeing, the Office of the Secretary of Defense, and the Office of Management and Budget (OMB) reached an agreement in May 2003 for the service to acquire 100 Boeing KC–767A aerial refueling aircraft through a complex financing arrangement. The Air Force submitted the required report to the Congress on July 11, 2003. In that report, the Air Force concludes that the proposed leasing arrangement meets all requirements of the Department of Defense Appropriations Act, 2002, which specified that the terms had to be consistent with the criteria for an operating lease as defined in OMB Circular A–11, *Preparation, Submission, and Execution of the Budget*. The report further concludes that, while leasing would cost about $150 million more (expressed in net present value terms) than an outright purchase, leasing is the preferred approach because of the "advantage it affords for quickly delivering needed tankers to our warfighters without requiring significant up-front funding."

After analyzing the Air Force's report and receiving additional information about the proposed lease from the Air Force and Boeing, the Congressional Budget Office (CBO) has concluded that the transaction would essentially be a purchase of the tankers by the Federal Government but at a cost greater than would be incurred under the normal appropriation and procurement process. The special-purpose entity that has been established to buy the aircraft would, in fact, be substantially controlled by and act on behalf of the Federal Government, and its transactions should be reflected in the Federal budget.

Even if one were to view the arrangement as a lease, CBO's analysis indicates that the proposal does not meet the conditions for an operating lease described in the *Congressional Scorekeeping Guidelines* and in OMB Circular A–11 and thus does not comply with the terms of section 8159 of the Department of Defense Appropriations Act, 2002.

Finally, CBO concludes that implementing the Air Force's proposed arrangement would be more expensive than the service has estimated. While the Air Force estimates that its proposal would cost $150 million more than an outright purchase, CBO's analysis indicates that the proposal would cost $1.3 billion to $2 billion more in present value terms, or 10 percent to 15 percent more than an outright purchase. On average, the Air Force would spend $161 million per plane in 2002 dollars to lease and then purchase the aircraft, compared to a cost of $131 million per plane for an outright purchase.

The Air Force's Plan to Acquire 100 Boeing Tankers

The Air Force plans to sign a single multiyear contract that will include leasing 100 KC–767A aerial refueling aircraft from a special-purpose entity, called the KC–767A USAF Tanker Statutory Trust 2003–1 (the Trust). The tankers will be delivered to the Air Force in six groups—four aircraft in 2006, 16 aircraft in 2007, and 20 planes annually over the 2008–2011 period. The Air Force will use each aircraft for six years and pay the Trust an average of $126 million a plane, in 2002 dollars, during that period. At the conclusion of each six-year period, the Air Force can return the aircraft to the Trust or purchase them for a price to be set when the contract is signed. The Air Force currently estimates the purchase price at an average of $35 million per plane in 2002 dollars. Thus, according to its estimate, the Air Force will pay an average of $161 million per plane to lease and then purchase the tankers.[1] The Air Force has not negotiated to purchase the planes directly, but on the basis of the leasing arrangement, CBO estimates that given multiyear procurement authority, the service could negotiate a contract for 100 tankers at an average price of $131 million per plane in 2002 dollars.

The Air Force will be able to terminate the deal prior to the completion of the contract by notifying the Trust one year in advance. However, that termination would be costly because the Air Force would have to make an additional payment equal to an annual lease payment on each aircraft and would have to reimburse the Trust for any additional costs that resulted from the decision to terminate.

Financing Arrangements for the Proposal

Boeing and the Air Force have established the special-purpose entity to execute the leasing arrangement and to finance the acquisition of the aircraft. Under the financing plan established by the Air Force and Boeing, the Trust will buy 100 KC–767A tankers from Boeing at an estimated average price of $131 million per aircraft (in 2002 dollars) and will borrow money to make progress payments to Boeing during the construction period for each group of aircraft.

As Boeing completes construction of each group of tanker aircraft, the Trust will issue bonds in the commercial bond market. Boeing and the Air Force estimate that the proceeds from the bonds will need to equal $138.4 million per aircraft (in 2002 dollars), enough to pay Boeing for the remainder that it is owed for the aircraft, repay the principal on the construction loans, and pay interest on the construction loans, which the Air Force estimates at an average of $7.4 million per aircraft.

Press reports indicate that there will be three classes of bonds. The Trust, which will technically own the aircraft, will use the Air Force's annual lease payments to pay principal and interest on two of the three classes of bonds. If the aircraft are sold at the end of the lease term, the proceeds will be used to pay off principal and interest on the last class of bonds. The price the Air Force may pay to acquire title to the tankers will be established for all 100 planes at the time the contract is awarded. That amount will be equal to the principal and interest owed on the third class of bonds. Under the terms of the agreement, if the Air Force should choose to forgo purchasing the aircraft and the aircraft are then sold to another purchaser for more than the amount owed on the bonds, any profits from the sale will be returned to the U.S. Treasury.

According to the Air Force and Boeing, the credit rating on the bonds will be based on the strength of the cash flow from the Air Force, rather than on Boeing's credit rating. For that reason, the Air Force expects that the Trust will be able to issue bonds at interest rates that are only slightly greater than Treasury rates. Interest rates on the bonds must compensate investors for the risk that the Air Force might terminate the contract early or might decline to purchase the aircraft at the end of the lease. CBO believes that the small risk premium estimated by the Air Force on borrowing by the special-purpose entity indicates that the Air Force assumes the market will perceive the debt as being backed by the Federal Government. (See Figure 1 for a graphic display of the financing arrangements.)

The Results of CBO's Analysis

CBO reviewed the information contained in the Air Force report, sections of the proposed contract, and the economic analysis prepared to support the Air Force's decision to lease. CBO found that the financing plan envisioned for acquiring the tankers constitutes Federal borrowing and spending under standard government accounting principles.[2] CBO also concludes that the proposal does not meet the conditions for an operating lease described in OMB Circular A–11 and thus does not comply with the terms of section 8159 of the Department of Defense Appropriations Act, 2002. While the Air Force acknowledges that acquiring the aircraft with this financing method is more expensive than purchasing them outright, its estimate of the

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[1] Payments under the Air Force's proposal are based on a negotiated purchase price of $131 million in 2002 dollars. Payments will be adjusted for inflation using a combination of the Employment Cost Index and the Industrial Commodities Index.

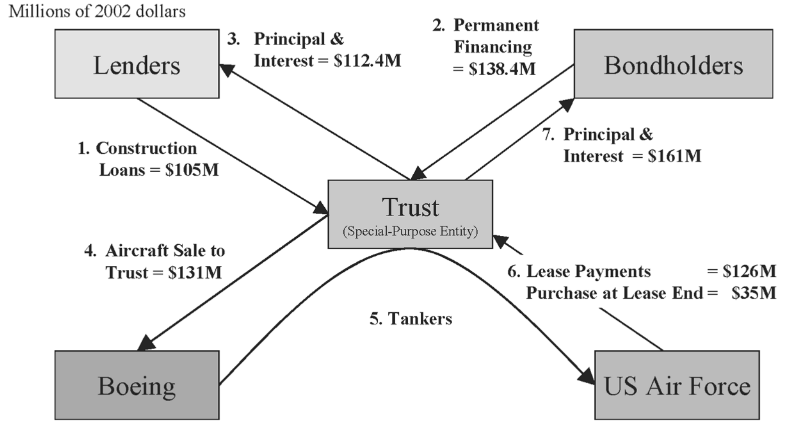
[2] The 1967 *Report of the President's Commission on Budget Concepts* suggests a broad definition of Federal budget activities, with a few narrow exclusions. It observes that "providing for national security . . . obviously constitutes activities of the Federal Government which should clearly be in the budget." Consistent with other recommendations by the Commission, CBO believes that when the government owns a significant part of an entity's assets or exercises substantial control over the entity's operations, that entity should be included in the Federal budget.

extra cost—at $150 million—is much less than CBO's analysis indicates. CBO concludes that the Air Force would pay $1.3 billion to $2 billion (expressed in net present value terms) more to lease and then purchase the tankers than it would to purchase them outright.

Figure 1

Costs Per Aircraft Under the Tanker Financing Plan

Millions of 2002 dollars



1. As Boeing builds the tankers, the Trust will borrow money from commercial banks to make progress payments to Boeing. CBO estimates that, on average, the Trust will borrow approximately $105 million per plane for progress payments.
2. Shortly before the planes are delivered, the Trust will issue bonds to raise $138.4 million per plane in permanent financing.
3. The Trust will use the bond proceeds to pay principal and interest on the construction financing loans, which CBO estimates will average $112.4 million per plane.
4. The Trust will use the rest of the bond proceeds to pay Boeing the remainder it is owed on the aircraft. Total payments to Boeing will equal $131 million per plane.
5. Boeing will transfer title to the planes to the Trust and deliver the aircraft to the Air Force.
6. The Air Force will make lease payments totaling $126 million per plane and a final payment of $35 million should it choose to purchase the planes at the end of the lease.
7. The Trust will use the Air Force's lease and purchase payments to remit $161 million in principal and interest to the bondholders.

SOURCE: Congressional Budget Office.

The Tanker Financing Plan Constitutes Federal Borrowing and Spending

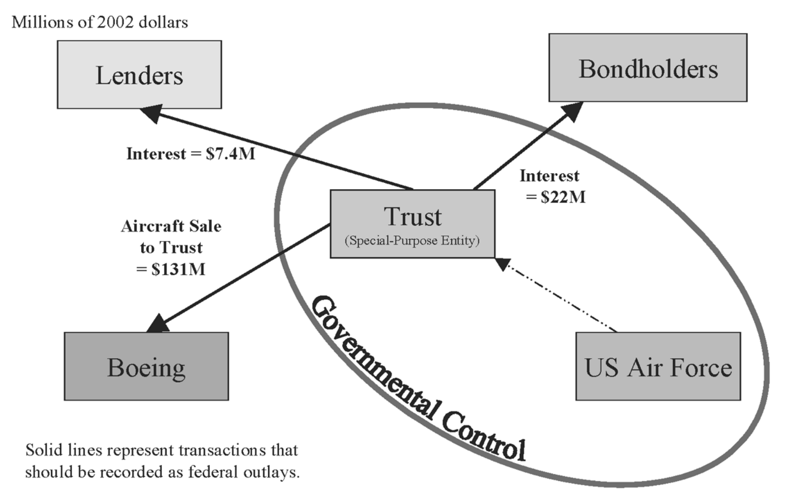
In its report to the Congress, the Air Force indicates that the Administration will record the tanker contract as an operating lease in the Federal budget once the contract is signed. Consequently, obligations and outlays will be recorded on a year-by-year basis, reflecting the lease payments due each year to the Trust. CBO believes that recording the transaction as such would be at odds with standard government accounting principles because the proposed financing constitutes Federal borrowing and spending. Therefore, the borrowing, resulting aircraft purchases, and interest payments by the special-purpose entity established specifically for this purpose should be recorded in the budget at the time the Trust makes those transactions.

The proposed contract between Boeing and the Air Force, as well as the financing arrangement, clearly indicates that the KC–767A USAF Tanker Statutory Trust 2003–1 exists solely to borrow money on behalf of the Federal Government to allow the Air Force to acquire an asset that has been built to its unique specifications. The borrowing activities of the special-purpose entity will be directed by a financing committee composed of the Air Force, Boeing, and the lease administrator. (The Air Force has asked Boeing to serve as the lease administrator.) Under the operating guidelines for the financing committee, the Air Force must approve all of the terms and conditions for the financing plan and must review and approve all financing documents.[3] CBO concludes that the actions of that committee will be explicitly controlled by the Air Force.

Because the government will both direct and benefit from the Trust's financing activities (see Figure 2), the Trust will be acting on behalf of the government. Therefore, its borrowing and spending should be treated as Federal borrowing and spending and recorded appropriately in the budget.[4] The parties to the lease portion of the contract are the Air Force and the Trust. Since the Trust is an instrument of the government, the government will effectively be buying the aircraft (via the Trust) and then leasing them to itself. To accurately reflect the nature of that arrangement, the Federal budget should report the transactions between the Trust and Boeing, and between the Trust and its bondholders, not the essentially intragovernmental transfers between the Trust and the Air Force. Thus, when the Trust pays Boeing for the aircraft, those payments should be reflected as Federal outlays. Subsequent interest payments on the Trust's borrowing should also be reflected as outlays when those payments are made. (Federal borrowing is not counted as a governmental receipt, and the repayment of principal is not counted as an outlay.)

Figure 2

Federal Outlays Per Aircraft Under the Tanker Financing Plan



SOURCE: Congressional Budget Office.

[3] Boeing provided CBO with a summary of the operating guidelines for the financing committee. It is available upon request.

[4] The Universal Service Fund is another example of a Federal program administered by a private agency for the Federal Government. The Universal Service Access Company (USAC), an independent organization that is regulated by the Federal Communications Commission, collects "contributions" from telecommunications service providers and makes payments to other service providers to ensure universal access to telecommunications services. Even though the collections and disbursements are not handled by the Treasury, USAC's transactions are included in the Federal budget. In 2002, the agent recorded revenue collections of $5.5 billion and expenditures of $5.1 billion in the Federal budget.

Table 1 displays how that budget authority and the associated outlays should be recorded in the budget compared with how CBO believes the department might reflect the contract in the budget. The table also shows CBO's estimate of the cost to purchase the tankers directly using traditional procurement methods. For budget purposes, all amounts are shown in current dollars.

The two budgetary treatments of the financing plan differ substantially. If the proposed transaction is recorded as a purchase, budget authority over the first five years would total $17.3 billion, and outlays would sum to $10.1 billion. If the transaction is recorded as an operating lease, only $1.5 billion in budget authority would be shown over the first five years, and outlays during that period would also total only $1.5 billion, because most of the aircraft would not be available for leasing until 2009.

TABLE 1. COMPARISON OF POSSIBLE BUDGETARY TREATMENTS OF THE KC-767A TANKER ACQUISITION

	By Fiscal Year, in Billions of Dollars														
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Total
TREATMENT OF THE TANKER FINANCING PLAN AS A LEASE-PURCHASE[a]															
Estimated Budget Authority	3.2	3.3	3.4	3.6	3.7	0.2	0.3	0.4	0.6	0.7	0.7	0.6	0.5	0.3	21.5
Estimated Outlays	0.2	1.0	2.3	3.2	3.5	3.7	2.9	1.3	0.6	0.7	0.7	0.6	0.5	0.3	21.5
TREATMENT OF THE TANKER FINANCING PLAN AS AN OPERATING LEASE															
Estimated Budget Authority	0	0	0.1	0.5	1.0	1.6	2.1	2.7	2.9	3.0	2.7	2.2	1.6	1.1	21.5
Estimated Outlays	0	0	0.1	0.5	1.0	1.6	2.1	2.7	2.9	3.0	2.7	2.2	1.6	1.1	21.5
DIRECT PURCHASE OF TANKERS[b]															
Estimated Budget Authority	1.4	2.5	3.0	3.0	3.0	3.0	0	0	0	0	0	0	0	0	15.9
Estimated Outlays	0.5	1.3	2.1	2.8	3.0	2.9	2.2	0.9	0.1	0.1	0	0	0	0	15.9

SOURCE: Congressional Budget Office.

NOTES: In the treatment of the financing plan as a lease-purchase, budget authority reflects the obligation by the Trust to purchase aircraft from Boeing and the obligation to make interest payments to creditors. Outlays reflect payments to Boeing during the time that it takes to construct and deliver the aircraft, as well as interest payments to creditors. In the treatment as a lease, budget authority and outlays equal annual lease payments. In the estimate of a direct purchase, budget authority and outlays reflect estimated costs of a straightforward purchase using the normal appropriation and procurement methods.

The figures do not include funding for operations and support or for military construction projects to house and maintain the new tankers.

a. If the Trust is not considered an instrument of the Federal Government, the acquisition should be treated as a lease-purchase. Consistent with *Congressional Scorekeeping Guidelines* and OMB Circular A–11, the budgetary treatment would be similar to that of a purchase.

b. The difference in total cost between a direct purchase and either treatment of the financing plan is almost $5.7 billion in current dollars.

In total, by CBO's estimates, acquiring the tankers through a lease would cost $21.5 billion over the next 14 years. In contrast, CBO estimates, a direct purchase of 100 tankers would cost $15.9 billion over the same period—but with all of the outlays recorded by the end of 2011.

Budget authority and outlays for the Air Force's proposed lease have two components: the purchase price of the aircraft and the interest costs from the financing arrangement. (Those costs include the additional expense of borrowing money at rates that exceed Treasury's normal borrowing rates.) If the Air Force's proposal is recorded in the budget as a purchase, the purchase price of the aircraft would appear in the first few years when the planes were being constructed, and interest would be recorded annually as the lease payments were made. Of the $21.5 billion shown in Table 1, $17.1 billion is for the purchase price of the aircraft, while budget authority for the imputed interest would total $4 billion over the 2006–2017 period. The remaining $0.4 billion would pay for insurance and other lease costs. Outlays for the purchase price, which would occur over the 2004–2011 period, would reflect progress payments during the construction period and final payments when the planes were delivered. Outlays for imputed interest charges would coincide with lease payments and would equal the annual budget authority for those charges.

Alternatively, if one chooses not to view the special-purpose entity as an instrument of the government, CBO concludes the arrangement should be reflected in the budget as a lease-purchase, not an operating lease as suggested by the Air Force and Boeing. In that case, the budgetary treatment would be similar to that of the financing plan treated as a purchase (shown in Table 1).[5]

The Proposal Does Not Meet the Criteria for an Operating Lease

After reviewing the details of the proposal, CBO concludes that it does not meet the conditions for an operating lease described in OMB Circular A–11 and thus does not comply with the terms of section 8159 of the Department of Defense Appropriations Act, 2002.

To comply with section 8159 and to be treated as an operating lease in the budget, the lease must meet the following six criteria:

- The asset must be a general-purpose asset, not built to unique government specifications.
- There must be a private-sector market for the asset.
- The present value of the lease payments cannot exceed 90 percent of the asset's fair market value at the start of the lease.
- The lease cannot contain a bargain-price purchase option.
- Ownership of the asset must remain with the lessor.
- The lease term cannot exceed 75 percent of the asset's useful life.

CBO has concluded that the arrangement between Boeing and the Air Force fails to meet the first four of these criteria and complies with the letter but not the spirit of the fifth.

The Lease Must Be For a General-Purpose Asset. Operating leases must be for a general-purpose asset, not one that is built to the unique specifications of the government. An aerial refueling tanker is not a general-purpose asset. Although the tanker is based on Boeing's commercial 767–200 model, the Air Force has specified several significant modifications such as auxiliary fuel tanks, a refueling boom, a refueling receptacle, more powerful generators, and heavier wiring to accommodate unique military requirements. The tanker's aerial refueling capability serves a uniquely governmental purpose.

There Must Be a Private-Sector Market. A private-sector market must exist for any asset obtained through an operating lease. The Air Force and Boeing assert that the lease meets this criterion because Boeing has offered the tanker, called the Global Tanking and Transport Aircraft (GTTA), for public sale. However, the only customers for the GTTA so far are the U.S. Air Force, the government of Japan, and the government of Italy, all of which plan to use the aircraft to refuel their military aircraft. Boeing states that there are a number of private companies that might purchase GTTA aircraft—Omega Air and the Tanker and Transport Service Company Ltd., in particular. CBO does not believe that those companies would buy more than a few of the tankers.

Boeing also points out that some long-haul commercial air carriers may be interested in acquiring the capability for aerial refueling, but none currently employs the technique. CBO believes it unlikely that aerial refueling would make economic sense for commercial transportation companies because they already have access to ground-based refueling services at airfields worldwide. Finally, while Boeing cites many potential customers for the freighter capability inherent in the tanker, how many of the 100 tankers reconfigured as freighters the private market would be able to absorb is unclear.

There are only about two dozen outstanding orders for all Boeing 767 variants. The KC–767A is derived from the Boeing 767–200C variant, for which Boeing has no version of 767–200 aircraft occurred in 2002, and Boeing has no future orders because it now produces 767 models that are superior to the 767–200. Thus, while there may be a private-sector market for a few of the aircraft that the government is acquiring, there is no evidence of such a market for 100 tanker aircraft.

Lease Payments May Not Exceed 90 Percent of the Fair Market Value. To qualify as an operating lease, the net present value of the lease payments may not exceed 90 percent of the fair market value of the aircraft. The Air Force report indicates that the lease payments under the proposed financing arrangement will account for 89.9 percent of the fair market value of the aircraft, which the Air Force calculates at $138.4 million (in 2002 dollars) when the cost of the construction loan financing ($7.4 million per aircraft) is included. CBO believes that including the cost of that

[5] For a more in-depth discussion, see Congressional Budget Office, *The Budgetary Treatment of Leases and Public/Private Ventures* (February 2003).

financing as part of the aircraft's fair market value is inappropriate because that cost is additional to any interest that would be capitalized in the price of the aircraft in the purchase option. When the financing cost is excluded from the calculation, the net present value of the lease payments accounts for 93 percent of the fair market value.

CBO also notes that, even using the Air Force's methodology, there is a significant possibility that the threshold of 90 percent of the fair market value could be exceeded for at least some of the groups of leased tankers. The lease payments are based on the Air Force's estimate of bond interest rates. If the rates for Treasury bonds are higher than the predicted value used by the Air Force, or if the spread on the interest rates for the bonds issued by the Trust is greater than predicted, lease payments will increase accordingly. Since the Air Force already estimates that the present value of the lease payments will be 89.9 percent of the fair market value, it has no margin for error on its estimate of interest rates.

The Lease Cannot Contain a Bargain-Price Purchase Option. The lease cannot contain an option to purchase the aircraft at a bargain price. The agreement gives the Air Force the option to purchase the aircraft at any time during or at the end of the lease. The Air Force estimates that it could purchase the aircraft at the end of the lease for an average $35 million apiece (in 2002 dollars), or 28 percent of the cost to purchase new tankers. Since the aircraft should last at least 30 years, the aircraft should have 80 percent or more of their life expectancy remaining after six years. While it is difficult to establish the fair market value of used tanker aircraft, CBO believes that paying 28 percent of the cost of a new tanker for a used aircraft with 80 percent of its life left constitutes a bargain purchase price.

Ownership Must Remain With the Lessor. Under the operating lease, ownership must remain with the lessor, and title may not transfer to the government at or shortly after the end of the lease term. CBO believes the Trust is an instrument of the government, given the level of control the government exercises over its operations. Thus, the Trust is effectively purchasing the tankers for the government.

However, if one chooses not to view the Trust as an instrument of the government, the financing arrangement technically complies with this criterion since the purchase option is contingent upon subsequent authorization and appropriation by the Congress. It seems clear for several reasons, however, that the Air Force fully intends to acquire the tankers during or at the end of the lease term.

First, the Air Force and Boeing plan to negotiate a purchase price for each group of planes when the contract is awarded. The Air Force has the right of first refusal on the disposal of the aircraft at the end of the six-year term. The Air Force has also stated its intention to earmark funds to purchase the aircraft.

Second, senior Department of Defense officials have stated on several occasions that the department has a long-term requirement for tankers and that the department plans to replace the entire fleet of KC–135 aircraft over the next 30 years. It seems implausible that the Air Force would return the 100 leased tankers to the Trust since the Air Force plans to retire 68 KC–135E tanker aircraft over the 2004–2006 period regardless of whether the lease is approved and will retire all 131 KC–135E aircraft by 2008 if the lease is approved. Moreover, it would have to accept a significant reduction in its aerial refueling capability if it chose not to purchase (or continue to lease) the KC–767 tankers at the end of the six-year term.

Finally, the Air Force's basing plan for the tankers includes more than $600 million in construction projects to support the permanent basing of the aircraft. Spending those funds would be uneconomical if the Air Force was seriously considering returning the aircraft at the end of the lease term.

The Proposed Financing Approach Is More Costly Than an Outright Purchase

The proposed financing arrangement to acquire the tanker aircraft is significantly more expensive than an outright purchase by the government because of the anticipated interest rates (which are higher than U.S. Treasury rates) and other costs that are unique to the leasing option. By CBO's estimates, total costs for a direct purchase, including the estimated costs for self-insurance, would be about $16 billion (see Table 2). The Air Force reports that it will pay $17 billion to lease the aircraft for six years and more than $4 billion to purchase them at the end of the lease term. Those payments include the interest expense on borrowing by the special-purpose entity. The Air Force will also pay about $400 million for insurance and other expenses related to the lease transactions. Thus, the Air Force estimates that the costs of acquiring the aircraft under the financing arrangement will total almost $22 billion in current dollars. On a present value basis, the leasing approach would cost $1.3 billion more than an outright purchase, CBO estimates. (The Administration uses a discounting methodology specified in OMB Circular A–94, *Guidelines and*

Discount Rates for Benefit-Cost Analysis of Federal Programs, which, CBO estimates, would result in a greater cost difference of $2 billion relative to a purchase.)

TABLE 2. COMPARISON OF COSTS BETWEEN A DIRECT PURCHASE AND THE AIR FORCE'S PROPOSAL (Billions of Dollars)

DIRECT PURCHASE		AIR FORCE'S PROPOSAL	
Procurement Costs	14.9	Lease Payments	16.6
Nonrecurring Engineering Costs	0.6	Purchase at End of Lease	4.4
Insurance[a]	0.4	Insurance	0.4
		Other Lease Costs	*
Total	15.9	Total	21.5
Present Value	**13.6**	**Present Value**	**14.9**

SOURCE: Congressional Budget Office.

NOTE: * = Less than $500 million.

a. If the Air Force were to purchase tankers directly, it would "self-insure." The value of insurance is shown here to make the total cost of the "direct purchase" option comparable to the Air Force's proposal.

The Air Force's Economic Analysis Understates the Cost Difference

In its report to the Congress, the Air Force indicates that leasing 100 air refueling aircraft will cost $150 million more than an outright purchase in net present value terms (see Table 3). CBO's analysis indicates that the estimate significantly understates the additional cost associated with the Air Force's plan. The Air Force, in fact, does not rule out that possibility, stating that "had the Congress chosen instead to provide multiyear procurement authority and had the Department of Defense been able to accommodate that execution while preserving program stability, the [net present value] could favor purchase by up to $1.9 billion."[6] The Air Force's report notes that this type of analysis is "highly sensitive to the underlying assumptions" but that "in no case approved by OMB did the financial analysis indicate that the net present value of the lease option as being less than that of a traditional purchase."

[6] The Air Force appears to attribute the large difference to the effects of multiyear procurement alone. In fact, CBO's analysis indicates that the assumption of multiyear procurement accounts for only $970 million of the $1.9 billion difference.

TABLE 3. MAJOR DIFFERENCES BETWEEN CBO'S ESTIMATE AND THE AIR FORCE'S ESTIMATE OF THE ADDED COST FOR LEASING VERSUS PURCHASING KC-767A TANKERS
(In millions of dollars)

	Additional Cost of Leasing (Net Present Value)
Air Force's Estimate	150
Impact of Changing Assumptions:	
Multiyear Procurement Savings in Purchase Price	+970
Proper Inflation of Progress Payments	+640
Compression of Progress Payments	+210
Discount Rate and Interactions Among the Above Factors	-650
CBO's Estimate	1,320

SOURCE: Congressional Budget Office.

Multiyear Procurement. For the lease, the Air Force and Boeing negotiated a price for the aircraft as delivered to the Trust on the basis of the assumption that the Air Force would ultimately lease and acquire 100 airplanes. That assumption allows Boeing to make investments in facilities and equipment that will reduce the total costs of production. It also allows Boeing to purchase parts and components in large quantities to get price breaks from suppliers. For its analysis of the purchase option, however, the Air Force assumed that each lot of aircraft would be bought on an annual basis (that is, with no assurances of subsequent purchases). Thus, no price breaks or production efficiencies were included in the estimated purchase prices.

For the purchase option, the Air Force increased the price of each aircraft by 7.4 percent relative to the price that it used for the lease. CBO believes that estimating the purchase cost under the assumption that a multiyear contract would be granted is warranted because, under section 8159, the Congress has already granted authority for the lease and would likely grant such authority for an acquisition program of that size. The Air Force's statement that it did not assume a multiyear procurement in its analysis of a purchase because it did not currently have that authority is inconsistent with its budgetary practices for other major acquisition programs. The department does not currently have multiyear procurement authority for either the F–22 fighter or the Joint Strike Fighter programs but assumes multiyear procurement in estimating the future purchase costs of those aircraft.

CBO estimates that the cost to acquire 100 KC–767A tankers under the proposed financing arrangement would exceed the cost of purchasing the aircraft under a multiyear contract by $1.1 billion (expressed in net present value terms), an increase of $970 million relative to the Air Force's results. Although the Congress has already granted multiyear authority for the lease, in traditional procurement programs, that authority is frequently provided after several years of production prove that the program is stable. If the Congress waited until the third lot to grant the authority, then, by CBO's estimates, the lease would cost $920 million more than the purchase, an increase of $765 million relative to the Air Force's estimate.

Inflation of Progress Payments. The Air Force's method for applying inflation to progress payments is another factor that affects the purchase price in its analysis. During the construction period, a contractor is continually paying for materials and labor. If the government paid the contractor for the full price of the asset at the time of delivery, the contractor would have to borrow money to cover those expenses and include the full costs of that borrowing in the purchase price. Progress payments reimburse the contractor for the costs the company incurs during the construction period and reduce the requirement for the contractor to borrow the money to cover expenses—resulting in a lower purchase price for the government. The government usually limits progress payments to a percentage of the actual costs incurred at the time the request for payment is made.

In its analysis of the cost of a straightforward purchase, the Air Force estimated progress payments as a percentage of the tanker's price, which it inflated to the year of delivery. CBO believes that that method overstates both the amount of the progress payments and the total cost of the aircraft since inflation would affect the cost of material and labor only up to the time those costs were paid. The method also conflicts with the DOD Comptroller's guidance on inflation, which calls for inflating costs to the year the order is made, using an inflation index that takes into account the fact that outlays will occur incrementally between the date the order is placed and the date the asset is delivered. CBO estimates that if the cost of progress payments were inflated only to the time those costs were paid, then the cost of the leasing arrangement would exceed the cost of a straightforward purchase by an additional $640 million (in net present value terms).

Schedule for Progress Payments. The schedule for making those progress payments is also a factor that affects the purchase price in the Air Force's analysis. For the option of purchasing the aircraft, the Air Force assumed that progress payments would begin approximately four years before the aircraft were delivered. The assumed payment schedule seems protracted for several reasons. First, the schedule is longer than that of other major aircraft procurement programs. For example, the budget for the C–17 transport program provides advance procurement funding just two years before the delivery date. Other procurement programs, like that for the F–22 fighter, assume that the majority of the progress payments are made over three years.

Second, the Air Force's aircraft procurement programs spend, on average, about 90 percent of budget authority within three years after appropriation. In contrast, the progress-payment schedule that the Air Force used in calculating the costs of purchasing tankers would expend only 75 percent of budget authority in three years, with the last 25 percent of the payments in the fourth year. That progress-payment schedule does not appear to reflect the Air Force and Boeing's plan to deliver the first KC–767A tanker approximately 34 months after lease approval and to deliver subsequent aircraft on an even faster schedule.

Using a four-year progress payment schedule increases the cost of the purchase option in net present value terms because it brings forward a large portion of the payments into a period in which the discount factors have less impact. The method appears to conflict with the Department of Defense's Financial Management Regulation, which limits progress payments to a percentage of incurred costs, because it would make payments before work commences. Using a three-year schedule for progress payments (one more in line with historical outlay rates for procuring aircraft) would defer some payments for one year relative to the schedule used in the Air Force analysis and would reduce the cost of the purchase by about $210 million in net present value terms.

Discount Rates and Interaction Among The Factors. The results of any economic analysis are sensitive to changes in the discount rate selected. Changes in the discount rate also affect the costs associated with assumptions made about multiyear procurement and progress payments. CBO has calculated the present value of cash flows associated with the planned acquisition of tanker aircraft by discounting the estimated cash flow for each year using the interest rate on a marketable zero-coupon Treasury security with the same maturity from the date of disbursement as that cash flow. That method—often referred to as the "basket of zeros" discounting approach—is used by both CBO and OMB for calculating estimates of loan subsidies under the Federal Credit Reform Act. Although the tanker acquisition plan does not explicitly involve a direct loan or Federal loan guarantee, the financing of tankers would result in a series of annual cash flows that have to be matched by the Trust's borrowing (on behalf of the government). Using the basket of zeros to discount that stream of cash flows most accurately reflects the time value of money. Under CBO's approach, the acquisition plan would cost about $1.3 billion more—in present value terms—than an outright purchase would.

In contrast, the Air Force's analysis relied on the simplified discounting method provided in OMB Circular A–94, which advises using a single discount rate (as opposed to the "basket of zeros"). In implementing the guidelines, the Air Force used a nine-year Treasury rate, based on a three-year construction period and a six-year lease term, to discount the lease payments. CBO estimates that this assumption would result in an additional cost to leasing of $1.7 billion.

However, CBO believes that if a single discount rate is used, the relevant period of analysis should be six years, since the Trust will issue bonds that mature in no more than six years. CBO estimates that using the Administration's method with a single six-year discount rate would yield an even larger present value difference—a greater cost of about $2 billion for the Air Force's plan.

Other Considerations

Termination Liability

Under the terms of the agreement, the Air Force can terminate the lease prior to the completion of the lease term for its convenience. However, exercising that option would be expensive for the Air Force because of the requirement to pay penalty payments, unamortized costs of the development of the tankers, and additional costs that would arise from its decision to terminate. If it terminates the lease, the Air Force might take delivery of the tankers under construction, make one year's lease payment, and within a year, return them to the Trust along with the penalty payment. Alternatively, it might choose to pay Boeing for the costs of work performed before the decision to terminate. CBO estimates that termination liability could be as high as $5 billion to $7 billion in some years. Under the authority in section 8117 of the Department of Defense Appropriations Act, 2003, the Air Force does not intend to set aside budget authority to cover this contingency and therefore would need an appropriation from the Congress to do so. Given the potential size of the liability and the fact that the Air Force does not intend to budget for it, CBO believes it is extremely unlikely that the Air Force will terminate the lease.

The Long-Term Affordability of Leasing and Then Purchasing Tankers

The Air Force states that its primary reason for choosing this financing arrangement is the favorable budgetary treatment that it will receive. This treatment would allow the service to get the tankers today without displacing other programs from its budget. However, the budget will eventually have to reflect the Air Force's decision to acquire the tankers. When those obligations are eventually recorded, mostly over the 2008–2017 period, they will create additional budgetary pressure in those years.

The Air Force report acknowledges that the lease is a more costly method to acquire the tankers, but the Air Force believes that its decision to pursue the method is justified by lower up-front costs. Total costs to the government are higher under the lease (almost $5.7 billion in current dollars, according to CBO's estimate), however, so rather than eliminating difficult budgetary decisions, the lease merely postpones them.

There is no reason to believe that the Air Force itself will have more budgetary flexibility 10 years from now than it has today. In 2012, for example, the Air Force will be making lease payments on the tankers that were delivered over the 2007–2011 period—about $2.9 billion (in current dollars) a year in payments. It will also have to begin purchasing the leased tankers at an estimated cost of $4.4 billion over the 2012–2017 period. Finally, the Air Force will have to decide how to replace the rest of its KC–135 fleet. Should the Air Force choose to buy more than 100 KC–767s, it would need to start purchasing those additional tankers in 2011 to keep the Boeing 767–200 production line in operation. Procuring 20 tankers annually would cost about $3 billion each year in current dollars, CBO estimates. Designing and building a new tanker would probably cost more and taker longer.

But the Air Force will not just be buying tankers with its aircraft procurement funds over this period. Other Air Force programs will require significant sums also. According to the Administration's published plans and cost estimates, by 2012 the Air Force will be buying 110 Joint Strike Fighters annually at a cost of almost $7 billion per year. Together, those two programs would consume about 70 percent of estimated funding for procuring aircraft. Thus, CBO concludes that the Air Force will likely be faced with making difficult budgetary decisions over the longer term also.

The CHAIRMAN. Thank you very much.

Mr. Curtin?

STATEMENT OF NEAL P. CURTIN, DIRECTOR, DEFENSE CAPABILITIES AND MANAGEMENT, UNITED STATES GENERAL ACCOUNTING OFFICE

Mr. CURTIN. Thank you, Mr. Chairman and Members of the Committee. I appreciate the opportunity to be here today to present GAO's observations on the Air Force's proposal.

Since my full statement will be placed in the record, I want to take just a few minutes here to highlight some of these considerations.

First, the Air Force acknowledges that leasing is more expensive than purchase, but its analysis indicates a net present value difference of only $150 million, favoring purchase, and that's out of a total program estimate of about $17 billion. Since this type of analysis is so sensitive to the assumptions used, we conducted additional sensitivity analysis to show the range of comparison between lease and purchase, and some of the sensitivity analysis shows the cost difference in favor of purchase could be as much as $1.9 billion in net present value; and that's an extra cost of over 10 percent for lease versus purchase, rather than the 1 percent extra shown in the Air Force report. We think——

The CHAIRMAN. Could I interrupt a second, Mr. Curtin?

Mr. CURTIN. Sure.

The CHAIRMAN. You're saying it's a one-point-——

Mr. CURTIN. $1.9 billion in net present value. That's somewhat equivalent to the CBO numbers, $1.3 billion, except for some differences in discount rates there. I think——

The CHAIRMAN. That was my question.

Mr. CURTIN.—I think there's a $600 million difference in the interest rates.

Mr. HOLTZ-EAKIN. And in one of the details of our report, we have an estimate that's $2 billion if you use an interest rate assumption similar to this.

Mr. CURTIN. So we're pretty much——

Mr. HOLTZ-EAKIN. We're in the same ball park.

Mr. CURTIN.—the same. So that's part of the difficulty——

The CHAIRMAN. Sure.

Mr. CURTIN.—of net present value analysis.

Senator STEVENS. Did either of your analysis include the savings of expenditures for maintenance?

Mr. CURTIN. No, sir, not ours.

Senator STEVENS. You don't take into account at all the savings of all these planes that are in platform being repaired.

Mr. CURTIN. Well, one comment on that. I mean, I recognize, yes, we'll be retiring over a hundred of these KC–135Es, and there are clearly maintenance savings there. The KC–767s are not without a maintenance cost, however. And I'm going to talk, in my statement, about the agreement the Air Force has made with Boeing to provide operations and support—you know, maintenance support for these aircraft, and that could be in the order of $6 million a year in this. It could be in the order of $5 billion over the course of this lease. So——

Senator STEVENS. It doesn't come close to the $5.5 billion savings in this estimate, in terms of——

Mr. CURTIN. Well, I think it's pretty close. We haven't done the analysis to compare exactly what the net difference in maintenance will be, but it's—it seems fairly close, from the analysis we've done.

Mr. HOLTZ-EAKIN. Mr. Senator, in our analysis, we've done an apples-to-apples comparison of the purchase of the same planes and the same schedule by two different financing schemes. Since the operation and maintenance would be the same in both cases, it's common to both, and the difference doesn't depend on that kind of an analysis.

Senator STEVENS. What?

Mr. HOLTZ-EAKIN. Ours is an apple-to-apples comparison.

Senator STEVENS. You're taking a 44-year-old plane and a one-year-old plane?

Mr. HOLTZ-EAKIN. In our analysis, we would replace the same old planes with the same new planes, and so the only difference is due to the lease method of financing the purchases.

Senator STEVENS. Now I know why we're running up such deficit, if that's the way you keep the books.

The CHAIRMAN. Please proceed, Mr. Curtin. Thank you.

Mr. CURTIN. A second point. The Air Force does really not make a case that leasing is cheaper. Instead, the real argument is that there's an urgent need to begin replacing the current tanker fleet, and leasing provides the aircraft earlier and more quickly than purchase, under current budget constraints. Leasing would provide the first planes in August 2006. Whereas, under the current procurement plan in the Air Force long-term budget, the first planes would not be received until Fiscal Year 2009.

In our view, the urgency of the need is really a matter of how much risk the Air Force and the Congress are willing to accept. The Air Force has not made replacement of the tanker fleet a procurement priority in past years. We pointed out, as Senator Cantwell mentioned, that, as far back as our 1996 report, that, yes, even then those were 35-year-old aircraft, and the Air Force needed to start looking at replacement in an orderly manner for that KC–135 tanker fleet. The Air Force said, at the time, and up until about 18 months ago continued to say that tankers were a lower priority and replacement could wait until later in this decade.

The KC–135s are increasingly difficult and expensive to maintain. No question. But the Air Force has been able to meet the heavy demands of the past two years with the existing fleet. The risk is that the aging planes would incur some fleet-wide problem in these intervening years that would jeopardize the mission, and there's really no way to predict how likely that is or how serious such a fleet-wide grounding might be.

A third point. The Congress also needs to be aware that, as part of this lease agreement, DOD plans to contract with Boeing for logistic support. That will total over $5 billion during the period of the lease. It comes to an average of about $6.4 million per year per aircraft for the KC–135s, in constant fiscal-year-2002 dollars. Boeing would handle all the maintenance above flight-line level.

We don't know, at this point, to what extent the Air Force considered other options for maintenance, such as competition or public-private partnerships, which might have bee more economical. There are many private contractors who perform maintenance now on commercial 767s. We've asked the Air Force for documentation on how they arrived at this pricing level for the maintenance agreement with Boeing, but what we've gotten from the Air Force really did not shed much light on the real basis for that price.

Fourth, there are also some issues to consider when the leases expire, at the end of this six-year period. Under the agreement, the aircraft are supposed to be returned to the owner, to the special-purpose entity. At that point, the aircraft, or the Air Force, would have made lease payments of about 90 percent or more of the value of the aircraft, and the Air Force would actually incur additional costs, estimated at about $778 million, to return those aircraft in the proper maintenance condition that's specified in the lease. But, more importantly, the Air Force would be losing tanker capacity if they actually turned those back in. They need that tanker capacity, and that would have to be replaced somehow. So what I'm really saying, I guess, is that even though the lease says, "We're going to turn these back after six years," if the Air Force really did that, I don't think the proposal makes much sense, either militarily or economically.

So what's really going to happen, and what the Congress needs to be aware of, is that the Air Force will seek authority and funding to purchase the tankers at the expiration of the leases; and, therefore, the full cost of this program needs to include the eventual purchase of these aircraft, and that's estimated, by the Air Force, at about $4 billion for the full hundred aircraft, and that's in then-year dollars, I believe, in current dollars.

The CHAIRMAN. So you tack on additional $4 billion for the inevitable purchase of the——

Mr. CURTIN. Down the road, we're going to have to purchase them.

Moreover, the tanker fleet consists of over 500 KC–135s, as has already been pointed out, and all of those are aging every year. They were 35 years old the first time we looked at it, and they're 43 years old now. Ten years from now, when this lease program is starting to wind down, those things are going to be 53 years old. There'll still be 400 aircraft averaging 50-some years old.

So the reasonable expectation is the Air Force needs to continue procurement beyond this first 100, and the problem with the leasing proposal is that it actually complicates the budget situation in future years. The advantage of leasing is it postpones payments and stretches them out. But the downside of that is that you'll still be making large payments on the first 100 aircraft, making these lease payments, at the time you're going to have to come up with additional procurement money for any follow-on aircraft. And in one of the analyses we did, we showed this could result in as much as a $6 billion per year budget requirement just for tankers in the Air Force budget in that 2012 to 2014 time frame. So there are some savings early on, but you create this bow wave, and there's a chart in our statement that illustrates that.

One final point. The lease agreement has not yet been finalized. The Air Force has told us the lease is still in draft and subject to further negotiation on a few points. So the Congress needs to be aware that some details of the lease could still change.

Just to sum up briefly, the lease proposal is clearly more expensive than outright purchase, and by an amount that we think is greater than the amount that the Air Force analysis shows. So, from a purely economic standpoint, this proposal probably does not provide the best return for the taxpayer. So it really comes down to a judgment of whether other factors outweigh the cost, and that's the judgment you'll need to make.

There is a need for new tankers, but the urgency of proceeding more quickly, three to five years more quickly, through this lease proposal has not been clear to has, has not been strongly made by the Air Force, because problems of the KC–135s have been known for some time and yet the Air Force has not made these tankers a priority for procurement funding.

So let me stop there, and my prepared statement actually contains some additional issues that I'd be glad to discuss, if you wish, and I'd be glad to take any questions.

[The prepared statement of Mr. Curtin follows:]

STATEMENT OF NEAL P. CURTIN, DIRECTOR, DEFENSE CAPABILITIES AND MANAGEMENT, UNITED STATES GENERAL ACCOUNTING OFFICE

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to appear before you today to discuss the Air Force's report on the planned lease of 100 Boeing 767 aircraft modified for aerial refueling. Aerial refueling is a key capability that is essential to the mobility of U.S. forces. Section 8159 of the Department of Defense Appropriations Act for Fiscal Year 2002 authorizes the Air Force to lease up to 100 Boeing 767 aircraft; the leased aircraft would be known by a new designation, KC–767A. The act also requires the Air Force to report to the Congress with a description of the proposed lease terms and conditions and any expected savings before proceeding. The Air Force sent its report to the Congress on July 10.

You asked for our analysis of the Air Force's business case and our views on the proposed lease arrangement. In my statement today, I will (1) summarize the proposed lease as presented in the Air Force's recent report to the Congress, (2) present our observations on the Air Force's lease report and its justification for the lease, and (3) identify related issues and costs that we believe the Congress will want to consider as it assesses the Air Force's proposal.

To summarize and analyze the report of the proposed lease, we reviewed the report to the Congress, examined the draft lease (which is still in negotiation and is subject to change), and reviewed documents and briefings from the Office of the Assistant Secretary of the Air Force for Acquisitions, Air Mobility Programs, to identify issues and costs that are material to the contract. We also reviewed the Air Force's analysis and data used in its analysis of the lease versus buy comparison as required by Office of Management and Budget (OMB) Circular A–94. Finally, we used data gathered for our ongoing review of tanker requirements being conducted for the House Armed Services Committee's, Subcommittee on Readiness.

Background

Aerial refueling is critical to carrying out our national security strategy because it allows other aircraft to fly further, stay airborne longer, and carry more weapons, equipment, and supplies. While numerous military aircraft provide refueling services, the bulk of U.S. refueling capability lies with the Air Force's fleet of 59 KC–10 and 543 KC–135 aircraft. These are large, long-range aircraft that have counterparts in the commercial airlines but have been modified to turn them into tankers. The KC–10 is based on the DC–10 aircraft, and the KC–135 is similar to the Boeing-707 airliner. Because of their large numbers, the KC–135 is the mainstay of the refueling fleet, and successfully carrying out the refueling mission depends on the continued performance of the KC–135. Thus, recapitalizing the fleet of KC–135s will be crucial to maintaining aerial-refueling capability, and it will be a very expensive undertaking.

There are two basic versions of the KC–135 aircraft, designated the KC–135E and KC–135R. The R model aircraft has been refitted with modern engines and other upgrades that give it an advantage over the E model. The E model aircraft on average is about 2 years older than the R model, and the R model provides more than 20 percent greater refueling capacity per aircraft. The E model is located in the Air National Guard and Air Force Reserve. Active forces have only the R model. Over half the KC–135 fleet is located in the reserve components.

The rest of the Department of Defense's (DOD) refueling fleet consists of Air Force HC–130 and MC–130 aircraft used by special operations forces, Marine Corps KC–130 aircraft, and Navy F–18 and S–3 aircraft. However, the bulk of refueling for Marine Corps and Navy aircraft comes from the Air Force KC–10 and KC–135. These aircraft are capable of refueling Air Force and Navy/Marine aircraft, as well as some allied aircraft, although there are differences in the way the KC–10 and KC–135 are equipped to do this.

The Air Force's Report on the KC–767A Aircraft Lease

Section 8159 of the Department of Defense Appropriations Act for Fiscal Year 2002,[1] which authorized the Air Force to lease the KC–767A aircraft, specified that the Air Force could not commence lease arrangements until 30 calendar days after submitting a report

to the House and Senate Armed Services and Appropriations Committees that would (1) outline implementation plans and (2) describe the terms and conditions of the lease and any expected savings. At about the same time that the Air Force submitted the required report (on July 10, 2003), it submitted a New Start Notification[2] and stated that it would not proceed with the lease until it received approval from all of the committees. The House and Senate Appropriations Committees and the House Armed Services Committee approved the new start in July. We previously testified before the House Armed Services Committee and its Subcommittee on Projection Forces, and we issued a briefing report in 2002 on the status of the proposed lease to date (see our Related GAO Products page for a complete list of products to date related to refueling requirements and the proposed lease).

The key elements of the Air Force's proposal, as presented in the report to the Congress, are summarized below:

- The Air Force proposes to lease 100 KC–767A aircraft for 6 years each; the first aircraft would be delivered in August 2006 and the final ones by the end of 2011. Leases on the final group of aircraft would terminate in 2017. The report indicates that the total program for the leased aircraft would cost about $17.2 billion in net present value over the lease period.[3]
- The Air Force's report includes an analysis required by OMB Circular A–94 comparing the net present value of the lease approach against that of purchasing the aircraft. The Air Force acknowledges that its analysis indicated that purchase would be cheaper than leasing by about $150 million in net present value terms. Nevertheless, it proposes to use the leasing approach because it allows the Air Force to take delivery of the aircraft more quickly than it could through purchase (and avoid creating major disruptions to other procurement programs for which funding has already been identified in the Future Years Defense Program). Specifically, the Air Force said that if the aircraft were purchased at the same rate as planned under the lease, it would need $5 billion more funding through Fiscal Year 2006 and more than $14 billion more for the 6 years reflected in the Future Years Defense Program. Under the procurement budget plan that the lease would replace, the Air Force would not begin acquiring new tankers until Fiscal Year 2009 and would not have 100 new tankers until 2016, 5 years later than planned through the lease.
- The key justification for the lease, according to the Air Force, is an urgent need to replace the current fleet of KC–135 aircraft. The Air Force has stated that the KC–135 is aging and becoming increasingly costly to operate owing to corrosion, the need for major structural repair, and increasing rates of inspection to ensure air safety. Moreover, the report indicates that the Air Force believes it is incurring a significant risk by having 90 percent of its aerial-refueling capability in a single, aging airframe and that a "fleet grounding" event could jeopardize the tanker's mission.[4]
- The Air Force plans to award a contract to a special purpose entity (SPE), a trust to be created under the laws of Delaware, that will issue bonds to raise sufficient capital to purchase the new aircraft from Boeing and lease them to the Air Force.[5] The entity is to issue bonds on the commercial market based on the strength of the lease and not the creditworthiness of Boeing. The lease is part of a three-party contract between the Air Force, Boeing, and the SPE.

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[1] Department of Defense and Emergency Supplemental Appropriations for Recovery from and Response to Terrorist Attacks on the United States Act, 2002, Pub. L. No. 107–117, § 8159, 115 Stat. 2230, 2284–85 (2002).

[2] The New Start Notification, submitted to the Armed Services and Appropriations Committees on July 11, 2003, was required by section 133 of the Bob Stump National Defense Authorization Act for Fiscal Year 2003, and is being used by the Air Force as the trigger for executing the lease. Pub. L. No. 107–314, § 133, 116 Stat. 2458, 2477 (2002).

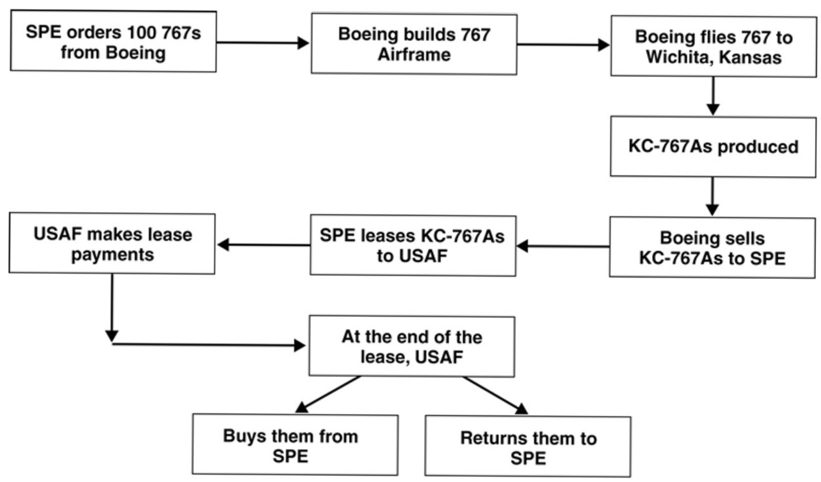
[3] When costs and benefits are evaluated over time, a net present value calculation is used to account for the time value of money through an interest rate called a "discount rate."

[4] A fleet grounding event would involve some systemic problem or equipment failure affecting all aircraft of the same type and would be serious enough to require replacement before the aircraft could resume normal operations.

[5] The special purpose entity would pay the interest on the bonds using lease payments it receives from the Air Force and would pay off all the bonds at the conclusion of the lease term.

Figure 1 depicts the relationships of the three parties to the contract and the transactions that are to take place under the contract, once it is signed.

Figure 1: Diagram of the Relationships of the Parties to the Contract and the Transactions That Are to Take Place Under the Contract



Source: GAO.

- Office of Management and Budget Circular A–11 requires that an operating lease meet certain terms and conditions, including a criterion that the net present value of the lease payments not exceed 90 percent of the fair market value of the asset at the time that the lease is initiated. The report to the Congress states that DOD believes the proposed lease meets those criteria and that payments over the life of the lease will be equal to 89.9 percent of the fair market value of the aircraft. At the same time, the report points out that the percentage is based on the cost to buy the aircraft—$131 million plus the cost of construction financing of $7.4 million, for a total of $138.4 million. If the fair market value is assumed to be the cost to buy the aircraft, then the lease payments represent about 93 percent of the fair market value and would not meet the requirement.
- If Boeing sells up to 100 comparable aircraft during the term of the contract to another customer for a lower price than that agreed to by the Air Force, the government would receive an "equitable adjustment." The report also states that Boeing has agreed to a return-on-sales cap of 15 percent and that an audit of its internal cost structure will be conducted in 2011, and that any return on sales exceeding 15 percent would be reimbursed to the government.
- According to the report, if the government were to terminate the lease, it must (1) do so for all of the delivered aircraft, and any aircraft for which construction has not begun, (2) give 12 months advance notification prior to termination, (3) return the aircraft, and (4) pay an amount equal to 1 year's lease payment for each aircraft terminated. If termination occurs before all aircraft have been delivered, the price for the remaining aircraft would be increased to include unamortized costs incurred by the contractor that would have been amortized over the terminated aircraft and a reasonable profit on those costs.
- The government will pay for and the contractor will obtain commercial insurance to cover aircraft loss and third-party liability as part of the lease agreement. Aircraft loss insurance is to be in the amount of $138.4 million per aircraft in calendar year 2002 dollars. Liability insurance will be in the amount of $1 billion per occurrence per aircraft. If any claim is not covered by insurance, the Air Force will indemnify the special purpose entity for any claims from third parties arising out of the use, operation, or maintenance of the aircraft under the contract.
- At the expiration of the lease, the Air Force can return the aircraft to the SPE after removing, at government expense, any Air Force-unique configurations added by the Air Force after delivery of the aircraft from the SPE. Alter-

natively, the Air Force also has the option to purchase the aircraft at residual value (the estimated value of the aircraft after the lease term ends). However, the purchase can take place only if it is authorized and funded by the Congress at or before the expiration of the lease.

- The contractor will warrant that each aircraft will be free from defects in materials and workmanship and that the warranty will be of 36 months' duration and will commence after construction of the commercial Boeing 767 aircraft but before they have been converted into aerial-refueling aircraft. Upon delivery to the Air Force, each KC–767A aircraft will carry a 6-month design warranty, 12-month material and workmanship warranty on the tanker modification, and the remainder of the original warranty on the commercial components of the aircraft, estimated to be about 2 years.

Our Analysis of the Air Force's Report and Lease Proposal

I will now present our observations on the Air Force's lease report to the Congress and on some of the details of the lease proposal. We believe there are a number of aspects of the report and lease that the Congress needs to be aware of in considering the Air Force's proposal, including the following:

- The cost differential between leasing and purchasing was presented by the Air Force as about $150 million favoring purchase in net present value terms, although the differential can rise to $1.9 billion favoring purchase, depending upon the assumptions used. For example, according to the Air Force report to the Congress, had the Congress provided multiyear procurement authority and had DOD been able to accommodate that while preserving "program stability," the net present value could favor purchase by up to $1.9 billion.
- The Air Force report states that there is an urgent need to begin tanker replacement 3 years earlier than previously planned, but until recently, recapitalization of the fleet has not been a high enough priority in the Air Force budget to successfully compete for funding.
- The Air Force proposal may not meet all the criteria specified by OMB to qualify as an operating lease since the Air Force would pay 93 percent of the fair market value of the aircraft if construction financing were not assumed to be included in the fair market value of the aircraft.
- As required by section 8159 of the Fiscal Year 2002 defense authorization act, the Air Force report to the Congress was limited to the costs of leasing the aircraft. However, the report does not present the total costs of this program, including the costs to acquire the aircraft at the expiration of the lease or to maintain the aircraft during the period of the lease.

Net Present Value Analysis

OMB Circular A–94 specifies that whenever a Federal agency needs to acquire the use of a capital asset, it should do so in the way that is least expensive to the government as a whole and further specifies how a lease versus purchase analysis should be conducted. Specifically, the circular directs a net present value comparison between the proposed lease and a hypothetical purchase on the basis of the same delivery and return profile. This approach permits an accounting for the time-value of money.

In its report to the Congress, the Air Force's net present value calculations between the proposed multiyear lease and a hypothetical purchase indicate that purchasing the aircraft would be cheaper than leasing by about $150 million; however, the report contains a footnote indicating that the net present value could favor purchase by an additional $1.7 billion (for a total of $1.9 billion less in costs compared with leasing). The $1.7 billion is based on four assumptions (all in net present value terms). First, the Air Force assumes that using a multiyear contract[6] for purchasing the aircraft would lead to $900 million in savings. Second, the Air Force assumes that using a shorter span of time for the period when progress payments[7] are made would lead to another $200 million in savings. Third, it assumes that if a shorter span of time for calculating inflation for progress payments is used, then savings of $500 million will occur. Fourth, it assumes that if a 30 percent discount on the imputed cost of insurance is included (since the government self-insures), savings of $100 million will occur.

[6] In multiyear procurement, all items are bought under one contract as opposed to a series of annual contracts.

[7] Progress payments, which are made to contractors before they deliver items, reduce contractors' financing costs and in turn result in a lower purchase price for the government.

The net present value analysis is also sensitive to the appropriate discount rate and other expected inflation. The Air Force followed OMB guidance contained in Circular A–94 in doing its analysis, to include using the discount rate of 4.1 percent. Our analysis shows that a 1-percentage point change in the discount rate can cause a change of over $660 million in the net present value results. Table 1 shows the sensitivity of the net present value analysis to different discount rates, including the discount rate of 4.2 percent that we would use on the basis of the July 10, 2003, date on which the report to the Congress was issued.[8]

Table 1: Sensitivity Analysis of Discount Rates for the A-94 Analysis

Dollars in millions

Discount rates in percentages	Net present value of leasing minus purchase
3.5	$567.6
4.1 (Air Force discount rate)	154.7
4.2 (GAO discount rate)	89.5
4.5	-100.4

Sources: Air Force (data); GAO (analysis).

The assumptions being used for the analysis regarding rates of expected inflation for construction of the aircraft, for military construction for facilities, and for operation and maintenance are reasonable; however, if the actual cost increases for the construction of the aircraft are higher than the assumed cost increases in the Air Force analysis, the cost of leasing will be higher than the cost presented in the report to the Congress. The reverse could also be true.

Urgency of Tanker Replacement

In its report to the Congress, the Air Force stated that "our National Security Strategy is unexecutable without air refueling tankers" and that "the risks involved with indefinitely operating a fleet of aging aircraft are unacceptable." These statements indicate that tankers are, or should be, a very high priority; however, the Air Force has for many years faced the issue of an aging KC–135 fleet and yet has not planned, until recently, to begin replacing them.

After reviewing a wide variety of Air Force reports and documents as well other documents, we have concluded that neither the Air Force nor DOD have been willing to make the difficult decision to reallocate procurement funds from other programs in the near term. For example, the Air Force put a replacement tanker program (known as the "KC–X") in its submission for the President's Fiscal Year 2004 budget. But in view of "affordability constraints" in the near term, the program would not begin to be funded until Fiscal Year 2006, and the first aircraft would be delivered in Fiscal Year 2009.

Until the authority to lease tanker aircraft was established by section 8159 of the Fiscal Year 2002 Department of Defense Appropriations Act, we did not perceive that concern within the Air Force about the condition of its KC–135 fleet was serious enough to successfully compete with other programs for funding. Instead, the Air Force has expressed belief in the necessity of continuing to operate and sustain the 540-plus aircraft fleet for several more decades, and it has also expressed confidence it its ability to do so, as illustrated in the following:

- In our 1996 report on aging tanker aircraft,[9] we stated that procurement of a commercial-derivative aircraft could take as long as 4 to 6 years and that development of a new aircraft could take up to 12 years. Therefore, we stated, the Air Force will need to quickly initiate studies to develop a replacement strategy for mobility aircraft and should consider a multirole aircraft that could be used for air mobility as well as aerial refueling. In response, DOD stated that "while the KC–135 is an average of 35 years old, its airframe hours and cycles are relatively low. With proper maintenance and upgrades, we believe the aircraft may be sustainable for another 35 years." Thus in 1996, the Air Force was planning

[8] The Air Force used a 9-year discount rate from Appendix C of Circular A–94, which is revised annually. The date of the revision used by the Air Force was January 2003. GAO policy for determining a discount rate is that it should be the interest rate for marketable U.S. Treasury debt with maturity comparable to the term of the project being evaluated. On the basis of the date the report was issued, the discount rate that we would use would be 4.2 percent.

[9] *U.S. Combat Air Power: Aging Refueling Aircraft Are Costly to Maintain and Operate,* GAO/NSIAD–96–160 (Washington, D.C.: August 8, 1996).

to continue to rely on the KC–135 aircraft until about 2030. The Air Force's comments notwithstanding, we pointed out at the time of our report that the long-term serviceability of the aircraft was questionable and we continue to believe it.

- *The KC–135 Aircraft Sustainment Master Plan* (1997), an Air Force strategic guide for investment, repair, and modification decisions, concluded that "with continued aggressive maintenance, the KC–135 will fly safely well beyond the FY 97–02 time frame." The report added that the aircraft can continue to be a safe and affordable weapon system that will meet the operational requirements well into the next century "if there is a consistent investment in maintenance and the aging aircraft programs."
- The Air Mobility Command's *Air Mobility Strategic Plan for 2002* (October 2001) established a time frame of Fiscal Year 2008–2013 to begin fielding an updated fleet of refueling aircraft. However, the report also identified additional problems hampering operations, including tanker aircraft and aircrew shortfalls, an increase in the number of KC–135 aircraft in the depot, and a decrease in mission capable rates. The strategic plan acknowledged that the KC–135 Programmed Depot Maintenance Improvement Plan had been developed to reduce the number of aircraft in the depot. In addition, the strategic plan indicated that an Analysis of Alternatives would be conducted over the next two years to determine the most effective solution set to meet the Nation's future air refueling requirements, although, to our knowledge, the analysis has not been done yet.
- In the *Mission Need Statement: Future Air Refueling Aircraft* (AMC 004–01, November 2001), the commander of the Air Mobility Command (AMC) stated that the "Air Mobility Command's priority is to continue with C–17 acquisition and C–5 modernization in the near term. As the airlift priority is met, AMC will begin to shift resources to address the next air refueling platform in the mid-to-long-term. Air Mobility Strategic Plan 2000 envisions KC–135 aircraft retirement beginning in 2013 with the concurrent fielding of a replacement air refueling platform." The mission need statement also stated that "definition of future air refueling mission needs and examination of opportunities for technology enhancement must begin in the near-term."
- In a May 2002 response to our briefing on our preliminary analysis to the Senate Armed Services Committee of the planned tanker lease, the Air Force stated that while it had programmed funds for a traditional replacement tanker since 2001, the first new aircraft would not enter the fleet until Fiscal Year 2009. The Air Force maintains an aggressive program of inspection and repair to keep the KC–135 fleet operational and to meet mission requirements. Consequently, while the KC–135 fleet was built from 1957 through 1965, significant portions of the aircraft have been upgraded or modified in the intervening years.
- From 1975 through 1988, the Air Force replaced about 1,500 square feet of the aluminum skin on the underside of the wings of most KC–135 aircraft with an improved aluminum alloy that was less susceptible to fatigue. In addition, engine strut fittings were replaced.
- Beginning in the mid-1980s, the Air Force began to replace the engines of the original KC–135A aircraft. Over 410 KC–135 aircraft have been converted to the R model by installation of fuel-efficient, quiet F108 (CFM–56) engines that enhanced the aircraft's performance and capability. In addition to new engines, this modification includes 25 other changes per plane, including reinforced floors, new and strengthened landing gear, reinforced wing structures, new engine struts, and over 12 miles of wiring.
- The Air Force modernized the cockpits on all of its KC–135 tankers through a program called PACER CRAG (compass, radar, and Global Positioning System receiver) to enhance reliability, maintainability, and capability.
- In addition to specific large-scale, fleet wide upgrade programs such as those that I described above, most aircraft have had major structural components replaced as necessary. Moreover, if—as KC–135 aircraft undergo their periodic programmed depot maintenance—trend analyses indicate the potential for fleet wide problems, some major components may be replaced on all aircraft. Examples of some of these major structural repairs include segments of fuselage skins, floor beams, fuselage bulkheads, and upper wing skins. As components such as these are replaced, the use of new and improved materials, fabrication, and corrosion prevention techniques are designed to solve problems and to last for the remaining life of the aircraft. In the case of the upper wing skins, for example, the Air Force reported, "as we work through the fleet, this level of re-

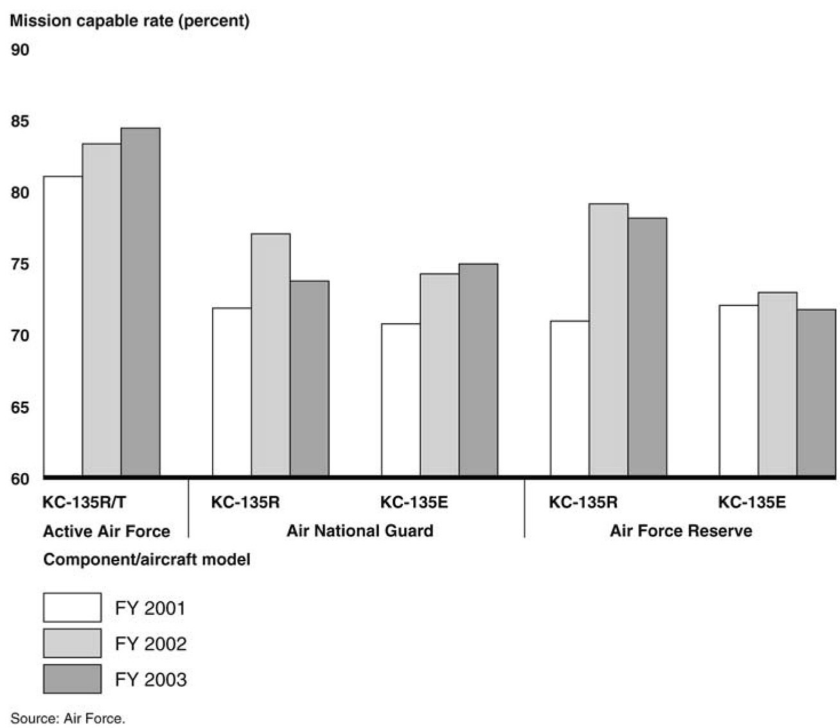
placement will decrease as most of the bad skins have been or shortly will be replaced. Replaced skins are installed with attention to corrosion prevention and should last more than 40 years."

Despite the Air Force's aggressive maintenance and upgrade programs to keep the KC–135 mission capable, since 2001, the Air Force has come to believe that the condition of the fleet has deteriorated to the point where replacement has become more urgent. For example, Air Force officials have cited the Air Force's *Economic Service Life Study,* which showed that program depot maintenance has become increasingly costly on the KC–135. Air Force officials told us that the E-model of the KC–135 is currently operating under flight restrictions owing to corrosion.

The KC–135 fleet averages over 40 years in age, but the aircraft have relatively low levels of flying hours. Flying hours for the KC–135 averaged about 300 hours per year from 1995 through September 2001. Since then, utilization is averaging about 435 hours per year. The Air Force projects that E and R models have lifetime flying hour limits of 36,000 and 39,000 hours, respectively—according to the Air Force, only a few KC–135 aircraft would reach these limits before 2040, at which time some of the aircraft would be about 80 years old.

The KC–135 fleet has not been meeting its mission capable rate goal. Mission capable rates measure the percentage of time on average that the aircraft are available to perform their assigned mission. The Air Force has a goal of an 85 percent mission capable rate for the KC–135 fleet. As shown in figure 2, KC–135 aircraft have not met the 85 percent mission capable rate in any of the last 3 Fiscal Years, although aircraft in the active component have consistently reached a mission capable rate of over 80 percent.

Figure 2: Average Annual Mission Capable Rates for KC–135 Aircraft by Service Component and Aircraft Type, Fiscal Year 2001–Fiscal Year 2003 (July)



Note: Fiscal year 2003 includes data through July 2003.

By most indications, the fleet has performed very well during the past few years of high operational tempo. Operations in Kosovo, Afghanistan, Iraq, and here in the United States in support of Operation Noble Eagle were demanding, but the current fleet was able to meet the mission requirements. Approximately 150 KC–135 aircraft were deployed to the combat theater for Operation Allied Force in Kosovo, about 60 for Operation Enduring Freedom in Afghanistan, and about 150 for Operation Iraqi Freedom.[10] Additional KC–135 aircraft provided "air bridge" support for the movement of fighter and transport aircraft to the combat theater, for some long-range bomber operations from the United States, and to help maintain combat air patrols over major U.S. cities since September 11, 2001.

According to Air Force projections, the KC–135 operating and support costs will increase substantially in the coming years. The costs for the current fleet totaled about $2.4 billion in Fiscal Year 2002 (2002 dollars). The Air Force projects that the cost will total about $3.5 billion (2002 dollars) in Fiscal Year 2012 for a fleet of 510 aircraft. According to Air Force officials, increased programmed depot maintenance costs were a significant cause of the increase. The officials said that, based on historical experience, programmed depot maintenance costs are expected to increase about 18 percent per aircraft per year. By the same projections, the operating and support costs for the fleet of 100 KC–767A aircraft will total about $808 million.[11]

The concept of an aging KC–135 fleet, and the problems and costs associated with operating and sustaining old aircraft, is not a sudden manifestation, but rather a fact of life that the KC–135 support infrastructure has had to deal with for years. Many of the problems currently being reported as reasons to begin tanker recapitalization immediately—including corrosion, increasing operating and support costs, and reduced aircraft availability—are not new and were issues that the Air Force was addressing in the mid-1990s, when we last examined aerial-refueling matters and when the Air Force concluded that recapitalization was not urgent.

Operating Lease Requirements

OMB Circular A–11 provides certain criteria that must be met for an operating lease:

- Ownership must remain with the lessor throughout the term of the lease and is not to transfer at or shortly after the end of the lease period.
- No bargain price purchase option is allowed.
- The lease term may not exceed 75 percent of the asset's economic lifetime.
- The present value of the minimum lease payments cannot exceed 90 percent of the fair market value of the asset at the beginning of the lease term.
- The asset must be a general-purpose asset and not government-unique.
- The asset must have a private-sector market.

The Air Force report says that the proposal complies with all of the criteria.

However, the report also points out that, depending on the fair market value used, the net present value of the lease payments in the case of the KC–767A may exceed the 90 percent of initial value threshold. On the one hand, if the fair market value is considered to include the cost of construction financing of $7.4 million per aircraft (or $740 million for all 100 aircraft),[12] then the lease payments are estimated to represent 89.9 percent. This is the formula that the Air Force used to document compliance with the circular and which the Air Force cited in its report to the Congress; it results in a cost of $138.4 million per aircraft. On the other hand, if the fair market value excludes construction financing, it totals $131 million per aircraft, and the lease payments represent 93 percent, thus exceeding the 90 percent threshold. According to the Air Force report, construction financing, however, must be included to meet the OMB Circular A–11 requirement.

However, it is not clear that including the construction financing represents the fair market value of the aircraft. The SPE will borrow money on the commercial market to raise funds to pay Boeing to finance construction of the aircraft and will repay the banks up to $7.4 million in interest on the loans per aircraft. Once constructed, the aircraft will be delivered to the SPE, and the SPE will pay Boeing $131 million less the amount of financing already paid to Boeing for the aircraft. The Air Force will then lease the aircraft for up to $138.4 million per aircraft over

[10] Air Force officials told us that combat commanders refused to permit the E-model of the KC–135 to be deployed to recent combat theaters.

[11] The projections assume that the KC–135Es and KC–135Rs will fly 308 and 368 hours per year while the KC–767A will fly 750 hours per year.

[12] Construction financing will be raised by the special purpose entity through borrowing in order to make progress payments.

the life of the lease. Consequently, the $7.4 million (reported by the Air Force as construction financing) represents interest on the loans to the SPE, and it is not clear that interest should be included in the fair market value of the aircraft.

Total Cost of the Program

While the Air Force report includes the cost of leasing and other government costs such as training, as well as operations and support, the report does not include the costs of buying the tankers at the end of the lease.[13] At the end of each 6-year lease, the aircraft are to be returned to the owner, the SPE, or they can be purchased by the Air Force for their residual value, estimated at about $44 million each in then-year dollars. If the aircraft are returned, the Air Force tanker fleet will be reduced, and the Air Force will have to find some way to replace the lost capability. In other words, the lease payments will have paid almost the full cost of the aircraft, and then the capability would be lost. Thus, the total cost of this 100-aircraft program should include the eventual acquisition cost. In addition to the cost to lease and subsequently purchase the aircraft, Air Force operations and support costs range from $4.6 billion to $6.8 billion, depending on which dollar calculation is used. The Air Force also plans to construct new facilities and would incur other costs ranging from $1.2 billion to $1.5 billion. Table 2 summarizes total cost in three different dollar calculations—then-year (or current) dollars, constant Fiscal Year 2002 dollars, and net present value.[14]

Table 2: Estimated Cost of the Contract to Lease, Maintain, and Purchase 100 KC-767A Aircraft Under Three Different Types of Analysis

Dollars in billions

Category	Net present value	Constant fiscal year 2002 dollars	Then-year dollars
Lease payments with aircraft return	$11.4	$12.3	$16.3
Aircraft purchase and other costs	3.1	3.4	5.2
Subtotal	**14.5**	**15.7**	**21.5**
Operations and Support	4.6	5.7	6.8
Military construction and other costs	1.2	1.3	1.5
Lease-buy Total	**$20.3**	**$22.7**	**$29.8**

Sources: Air Force (data). GAO (analysis).

In addition, the Air Force will have to pay an additional estimated $778 million if the entire 100 aircraft are returned, to ensure that the aircraft are returned in the maintenance condition specified in the lease. For these reasons, returning the aircraft would probably make little sense, and the Congress will almost certainly be asked to fund the purchase of the aircraft at their residual value as the lease expires.

Related Issues and Concerns

Our preliminary analysis indicates that certain other costs associated with the lease may deserve further examination by the Congress. Specifically, we have concerns related to contractor logistics support, the extent of Boeing's profit margin, and the impact of the lease on follow-on tanker acquisitions.

Contractor Logistics Support

The Air Force estimates that the maintenance agreement with Boeing will cost between $5 billion and $5.7 billion during the lease period. It has negotiated a non competitive agreement with Boeing as part of the lease negotiations, covering all maintenance except flight-line maintenance, which is to be done by Air Force mechanics. This represents an average of about $6.4 million per aircraft per year in Fiscal Year 2002 dollars. We do not know how the Air Force determined that this was a reasonable price or whether competition might have yielded savings because

[13] The Department of Defense and Emergency Supplemental Appropriations for Recovery from and Response to Terrorist Attacks on the United States Act, 2002, Pub. L. No. 107–117, § 8159, 115 Stat. 2230, 2284–85 (2002) required that the Air Force report on the costs to purchase or lease the aircraft but did not require that other costs be reported.

[14] Current dollars or then year dollars are the dollar value of a good or service in terms of prices at the time the good or service is sold. These contrast with constant dollars, which measure the value of purchased goods or services at price levels that are the same as those for the base year. Constant dollars do not contain any adjustments for inflationary changes that have occurred or are forecasted to occur outside the base year. When costs and benefits are evaluated over time, a net present value calculation is used to account for the time value of money through an interest rate called a "discount rate."

the Air Force did not provide sufficient documents on a timely basis for us to evaluate its price analysis. A number of commercial airlines and maintenance contractors already maintain the basic 767 commercial aircraft and could possibly do some of the required maintenance if given the opportunity to compete for the contract.

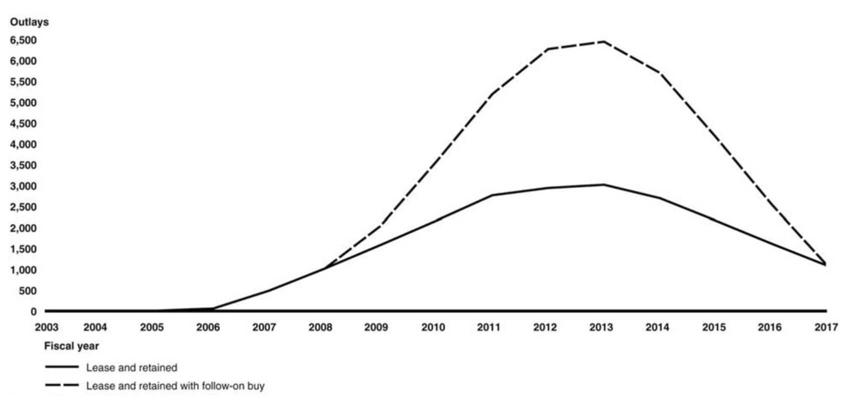
Profit Margin

The Air Force report indicates that Boeing can earn no more than a 15 percent profit on the Boeing 767 aircraft and that an audit will be conducted after the final planes are delivered to ensure that the company's profit does not exceed that amount. However, since this aircraft is basically a commercial 767 with modifications to make it a military tanker, it is not clear why the 15 percent profit should apply to the full cost. One financial analysis published recently states that Boeing's profit on commercial 767 aircraft is in the range of 6 percent.[15] If the Air Force negotiated a lower profit margin on that portion of the cost, with the 15 percent profit applying only to the military-specific portion, this could lower the cost by several million dollars per aircraft. For example, assuming the commercial tanker portion of the cost is about $80 million, the difference between profits of 6 percent and 15 percent would be about $7 million per aircraft, or $700 million for all 100 aircraft.

Effect on Follow-on Tanker Acquisitions

One of the key advantages of leasing is that it enables the Air Force to take delivery of aircraft without the large, up-front obligation of funds required for purchase; thus by the end of Fiscal Year 2011, the Air Force will have received 100 new tankers. The flip side of this, however, is that payments are spread out over many years and represent an obligation that must be met throughout the term of the lease. The Air Force will be making lease payments on the leased aircraft through Fiscal Year 2017, and will likely pay about $4.4 billion (in then-year dollars) in Fiscal Years 2012–17 to purchase the aircraft at the expiration of the lease. Funds spent during those years on these 100 aircraft are therefore funds that are not available for the procurement of additional tanker aircraft that will be needed to replace the remaining 400-plus aircraft in the KC–135 fleet. If the Air Force wants to procure additional tankers starting in this 2012–17 period, it will need an even larger budget during those years to accommodate both the continuing lease payments and new procurement. Figure 3 illustrates the annual outlays that would be required to lease the aircraft as proposed and the additional outlays needed to purchase an additional block of 100 aircraft. This assumes that delivery of the additional aircraft would begin after the first 100 had been delivered. If additional aircraft are to be obtained before the planned end of delivery of the first 100 leased aircraft in 2011, then the additional funds for the second block of aircraft would be needed even sooner.

Figure 3: Outlays Required to Lease 100 Aircraft and to Subsequently Purchase an Additional 100 Aircraft



Source: GAO analysis of Air Force data.

Mr. Chairman, this concludes my prepared statement. I would be happy to answer any questions that you or Members of the Committee may have.

The CHAIRMAN. Thank you.

[15] See Morgan-Stanley, *Does 767 Tanker Equate to 700+ Comml Orders?,* (May 30, 2003).

Mr. Bolkcom?

STATEMENT OF CHRISTOPHER BOLKCOM, SPECIALIST IN NATIONAL DEFENSE, CONGRESSIONAL RESEARCH SERVICE

Mr. BOLKCOM. Mr. Chairman, distinguished Members of the Committee, thank you very much for inviting me to speak with you today.

Before I begin, I'd like to briefly recognize my colleagues, sitting a couple of rows behind me here, Amy Belasco, Daniel Else, and Ronald O'Roarke, who are my co-authors on a recent CRS report on this subject and are here today to lend their expertise to my testimony.

I'd like to emphasize four points that I'll treat at greater length in my written statement and in the CRS report.

The first point centers on the issue of urgency. The Air Force bases much of its argument in support of this lease in their assertion that they have an urgent need to replace the KC–135E fleet. The Air Force says that the 135s must be replaced quickly because the aircrafts O&M costs are rising, yet its operational availability is declining. High operations tempo, they say, is worsening both cost and availability. The Air Force says that corrosion problems make the 135s prone to catastrophic failure, and this could ground the entire fleet. Also, it says that the 767 production line could close soon; thus, we must lease now while we have the opportunity.

There are critics of this lease, and CRS notes that some of their counter-arguments include that 135 costs may be manageable and lower than the overall costs of leasing the 767. Recent 135 availability is promising, and the 135's risk of catastrophic failure could be no worse today than it was two years ago, when the Air Force found it to be acceptable. Also, the 767 production line appears viable until at least 2006, and perhaps 2008.

The second issue that CRS examined is whether the 767 is the best aircraft for the job. In short, no one can answer this definitively, because the Air Force has not, and has not been required to, conduct an analysis of alternatives. It is unclear if the 767 meets all of the service's operational requirements. It is also not clear that the Air Force has vigorously explored other options, such as purchasing surplus commercial airplanes.

Finally, re-engining 135Es would improve tanker capabilities faster and at less expense than the lease, but the Air Forces opposes this on a few different grounds, primarily economic.

The third issue that CRS examined was how much a 767 lease might compare to a purchase. The Air Force's July 10 report to Congress states that leasing the 767s would cost 150 million more dollars than purchasing them, when calculated on a net present value basis. Now, this calculation is based on a number of assumptions that, if treated differently, could change the cost comparison by hundreds of millions of dollars. One of these assumptions concerns a discount rate used in the net present value calculation. The Air Force used a nine-year Treasury bond rate in its discount rate. CRS's analysis suggests that a more appropriate discount rate would be a three-and-a-half to four-year Treasury bond rate, which equates to the average maturity of the bonds that the U.S. Government were to use if it were to finance the cash flows of this lease.

Using such a discount rate would favor the purchase option by an additional $500 to $600 million.

A second factor was whether multi-year procurement should be used in estimating the cost of the purchase. The Air Force argues that this multi-year lease should be compared to annual procurement. But there are several arguments for why multi-year procurement would be appropriate in the calculation. If multi-year procurement were used to estimate the cost of a purchase, it would favor that option by an additional 600 million to 1.2 billion in discounted dollars.

The fourth and final issue that CRS examined were the potential budget oversight concerns that may be presented by this lease. If the Air Force's new start reprogramming request is approved, it will sign a contract committing the government to spend almost 25 billion, in current-year dollars, over the next 15 years. Starting a major Defense program without going through the normal appropriations and authorization process would be unusual, if not unprecedented. Moreover, it appears that the cost of the program would be subject to some market volatility. If bond rates, for instance, are, say, 1.5 percent higher or lower than currently anticipated, the program's cost could change, in either direction, by about 1.3 billion in current-year dollars.

Lease supporters and lease critics debate whether the proposal complies with statutory and OMB requirements. The Air Force says that the 767 proposal meets all criteria for operating leases; however, the proposal does appear to have many attributes that appear more similar to a capital lease or a lease purchase, which would require that more costs be scored up front in the Air Force budget.

In conclusion, it's not clear whether the lease is a "good deal" for the government. Based on a typical formula for commercial leases, the 767 proposal should cost between $59 million and $95 million per aircraft over a six-year period. Instead, this lease is estimated at 166 million per aircraft, in current-year dollars.

The CHAIRMAN. Repeat that, please.

Mr. BOLKCOM. Well, based on a typical formula we learned about in a HASC hearing in July, typically you'd expect the lease to cost between 59 million and 95 million per aircraft over a six-year period. Instead, this lease is estimated at 166 million per aircraft, in current-year dollars.

This concludes my remarks, Mr. Chairman. Thank you for the opportunity to appear today, and I look forward to your questions.

[The prepared statement of Mr. Bolkcom follows:]

PREPARED STATEMENT OF CHRISTOPHER BOLKCOM, SPECIALIST IN NATIONAL DEFENSE, CONGRESSIONAL RESEARCH SERVICE

Mr. Chairman, distinguished members of the Committee, thank you for inviting me to speak to you today about out study of the proposed KC–767 lease. Before I begin, I would like to recognize my colleagues Amy Belasco, Daniel Else, and Ronald O'Rourke, who are co authors of CRS's recent report on this subject, and are here today to lend their expertise to this testimony. Importantly, while CRS undertook this analysis to inform the debate on congressional options, CRS takes no position on any particular legislative option.

In this testimony I would like to emphasize four points that you will find treated at length in the CRS report published August 29. Our assessment suggests that there are four key issues that Congress may wish to address when considering the lease proposal:

- First, whether there is an urgent need to replace the KC–135E fleet
- Second, whether the KC–767 is the best airplane for the job
- Third, whether the cost comparison the Air Force has made between leasing and procurement is authoritative, and
- Fourth, whether this lease captures the government's full budgetary obligation and is a good deal for the government.

Is there an urgent need?

The Air Force bases much of its argument in support of this lease on its assertion of an urgent need to replace the KC–135E fleet. The Air Force indicates that leasing will result in faster deliveries than outright purchasing.

The Air Force makes five arguments for why replacing the KC–135Es must be done as soon as possible. First, because KC–135E operations and support costs are rising quickly. Recent Air Force studies project KC–135 O&S costs will be 50 percent higher than projections two years ago. Second, these aircraft are increasingly difficult to maintain. They will spend more time in maintenance depots, and less time in the hands of our warfighters. Third,thatthese aging aircraft are becoming increasingly prone to catastrophic failures that could unexpectedly ground a large segment of the tanker fleet. The Air Force's difficulties in addressing the KC–135's corrosion problems are most frequently mentioned as an unpredictable problem that could ground the fleet. Air Force officials say that they have "no confidence" in the KC–135E aircraft. Fourth, the Air Force argues that Boeing's 767 production line could close in the near future, and if the Air Force doesn't act now, the aircraft may not be available in the future. Finally, KC–135 usage rates in the post September 11 environment are higher than ever anticipated, which is prematurely wearing out these aircraft. The global war on terrorism may require the military Services to engage our adversaries in far flung theaters with little or unreliable in-theater basing. Without strategic aerial refueling capabilities, the Air Force argues, the United States would be nothing more than a regional power.

As part of its analysis, CRS found many counter arguments to the Air Force's position on urgency. Critics of the Air Force position note that the KC–767 lease only results in faster deliveries of the aircraft than procurement because of the Air Force's self imposed budgetary constraints. Procuring these aircraft could result in deliveries at the same rate as leasing, but, the Air Force would have to decrease near-term funding for other procurement programs. Thus, if the Air Force truly had an urgent need, critics assert, the Air Force would find other programs in its current plan that were less important, and make them bill payers for the KC–767. Along this same line of reasoning,lease critics argue that the Air Force has for years downplayed the need to recapitalize the KC–135 fleet, despite encouragement by organizations like the GAO, which has argued since 1996 that the Air Force should make recapitalization a higher priority.

Opponents of the lease are also critical of the five Air Force arguments outlined earlier. Critics state that the KC–135 operating costs are controllable and will be far lower than the overall costs of leasing the 767. Critics also say that while availability has been a problem for the KC–135 for some time, mission capable rates for the aircraft have been more than satisfactory, and that improvements to the KC–135 depots in 1999 and 2000 are now paying off in terms of faster maintenance turn around times. Lease critics say that the Air Force's depiction of the KC–135's corrosion is exaggerated, especially in terms of predictability. Some point to the Navy, which has been dealing with corrosion problems for years, and considers corrosion a "known challenge" that can be dealt with proactively. Some opponents characterize the KC–135's vulnerability to catastrophic failure as no worse today than it was two years ago, when the KC–135 Economic Service Life Study found it acceptable. Finally, lease critics say that Boeing's 767 production line is not in imminent danger of shutting down; that it is viable until at least until 2006, perhaps until 2008 and even beyond.

Is the KC–767 the right airplane?

If acquired, the KC–767 may be in DOD's inventory for 50 years. Therefore, the aircraft's capabilities and characteristics are an important consideration. Servicemen and women decades in the future will live with decisions made today.

Because the Air Force has characterized its need as urgent,supporters ofthe KC–767 say that the number of tanker aircraft platform choices are limited to some degree. Designing and building an aerial refueling aircraft from scratch, for instance, would take too long. The 767 is the best aircraft available right now, lease supporters say.

The Air Force says that the KC–767 is a much better aircraft than the KC–135. It is more capable, and flexible. It will offload more fuel, operate from shorter runways, and carry more cargo and personnel than the KC–135. Unlike the aircraft it will replace, the KC–767 is itself refuelable, and can use both the Air Force refueling boom and the Navy refueling probe and drogue system on the same mission. The Air Force projects that the KC–767 will be more available than the KC–135. It will have a higher mission capable rate, and spend less time in maintenance depots.

Newer aircraft always compare favorably to old aircraft, say lease critics. What really counts, they say, is how well the KC–767 meets the Air Force's, Navy's and Marine Corps' operational requirements. Critics argue that the KC–767 fails to meet a few key criteria. The KC–767 will not, for example, be able to simultaneously refuel two aircraft with the probe and drogue system. Opponents also say that significant numbers of inexpensive surplus commercial aircraft are available that may be even better than the KC–767. Some assert that surplus DC–10 aircraft could be purchased on the commercial market and converted into very capable KC–10 tankers for much less than the KC–7671ease. KC–1Os are roughly twice as capable as the KC–135. Furthermore,because the Air Force already operates 59 KC–10s today, it has already invested in the operations, maintenance, personnel and training infrastructure.

The Air Force opposes re-engining KC–135E models, arguing that it is economically unviable. Too little military capability is gained for the financial investment,and re-engining does not address the most basic need, which is to extend the KC–135's lifetime. Lease opponents look at the economics of re-engining and come to the opposite conclusion. It is much cheaper, they say, than leasing KC–767s. Re-engining merits consideration,lease opponents say, and note that Congress has provided funds tore-engine KC–135E aircraft for years.

Is the Air Force comparison of lease and procurement costs authoritative?

The Air Force's July 10 report to Congress states that leasing the 767s would be about $150 million, or about 1 percent, more expensive than purchasing them, when calculated on a net present value basis.

The report presents this $150-million difference (calculated on a net present value basis) as a single answer to the question of how the costs of leasing vs. purchasing the 767s compared to one another. The calculation, however, includes a number of assumptions and factors that, if treated differently, could change the outcome of the cost comparison, in several cases by hundreds of millions of dollars.

Some of these assumptions could change the calculation to favor either the lease option or the procurement option. But other assumptions, if treated differently, would more likely change the calculation in only one direction—in favor of the procurement option.

Perhaps the most significant factor we examined was the discount rate used in the net present value calculation. The Air Force used a 9-year Treasury bond rate. Our analysis indicated that an arguably more appropriate discount rate would be a Treasury bond rate for bonds having an average maturity equal to the bonds that the U.S. Government would likely use if the government needed to raise the funds for the cash flows involved in the lease arrangement. Jane Gravelle, a CRS senior specialist who is an expert on discount rates assisted in this part of the study.

Our analysis calculates this average maturity at something between 3.5 and 4 years, rather than the 9-year rate used by the Air Force. Using a 3.5- or 4-year Treasury bond rate would favor the procurement option by an additional $500 to $600 million.

A second major factor we examined was whether multiyear procurement should be used in estimating the cost of the procurement option. The Air Force report offers some arguments as to why multiyear procurement should not be used. But there are also arguments one could make as to why multiyear procurement *should* be used,including the fact that the lease inherently involves making a multiyear commitment, and that acquiring the aircraft through a multiyear procurement arguably would represent no more of a procedural innovation, and arguably less of one, than acquiring them through a lease.

If multiyear procurement were used in estimating the cost of the procurement option, it would favor the procurement option by an additional $600 million to $1.2 billion.

The use of multiyear procurement, if combined with the change in discount rate just mentioned, could shift the cost comparison in favor of the procurement option by a total of $1.1 billion to $1.8 billion.

The five other factors we examined included the following:

- The progress payment schedule, which if done to reflect other Air Force aircraft procurement programs, could favor the procurement option by an additional $200 million
- The treatment of inflation on the progress payments, which if done differently could favor the procurement option by an additional $500 million
- The interest rates on the bonds issued by the SPE, which could shift the cost comparison by about $270 million in either direction for each ½-point difference between projected interest rates in the Air Force calculation and the actual rates that occur when the bonds are issued
- The interest rates on the construction loans, which might shift the cost comparison by several tens of millions of dollars in either direction for each ½-point difference between the projected rates in the Air Force calculation and the actual rates that occur when the loans are taken out

and

- The imputed self-insurance cost that is included in the procurement option. This estimate could prove to be either to high or too low, possibly by tens of millions of dollars.

The two principal implications of CRS's assessment of the Air Force cost comparison are as follows:

- First, the $150-million difference in net present value between lease and purchase options that is presented in the Air Force report is one of many possible answers to the question of how the cost of the lease and purchase options compare to one another. Calculating the net present values of these two options involves several assumptions and factors that can shift the cost comparison, in several cases by hundreds of millions of dollars.
- Second, while some of the assumptions used in the calculation could change the outcome to favor either the lease option or the purchase option, other factors, if treated differently, are more likely to change the cost calculation in only one direction—in favor of the procurement option.

What budget oversight concerns are raised by the lease?

Consideration of the Air Force tanker leasing program has been unconventional. The Department of Defense (DOD) did not request any funds for the tanker lease in either FY2003 or FY2004, and has not included funding for the lease in its planning document, the Future Years Defense Program (FYDP).[1] The Air Force is relying on a provision in the FY2003 DOD Authorization Act that allows it to submit for approval a new start notification to the four congressional defense committees.[2]

If the four congressional defense committees approve the Air Force request to spend $720,000 in 2003 for a study of tanker maintenance and training requirements, the Air Force will sign a contract with Boeing to spend $24.6 billion in current year dollars between 2003 and 2017 on its new 767 tanker leasing program according to the Air Force. This would be an unusual if not unprecedented way to approve a major defense program.

First, it appears that the tanker lease may not alleviate the competition among programs in the Air Force budget. Operating leases are attractive because agencies can make smaller payments initially and spread out their payments rather than paying up front for a purchase. While the lease approach reduces Air Force budget requirements in the short term, it does so by pushing costs out into future years when potential trade-offs among programs are less visible to policy makers but may be equally difficult. Under the Air Force's plan, $5.5 billion would be needed in the first seven years of the lease—from FY2003 to FY2009—but $19.9 billion.would be needed in the second seven years of the lease—from FY2010 to FY2017.

In later years, the Air Force could face a squeeze on funding because of its plans to buy the Joint Strike Fighter, the F/A–22, R&D on a long-range bomber and a replacement of the Minuteman intercontinental missile, and other programs. A recent CBO report predicts that funding for Air Force investment programs would

[1] The Air Force did include $4.1 billion between FY2003 and FY2009 to buy a KC–X, an unidentified new tanker.

[2] Section 133 of P.L. 107–314, the FY2004 DOD Authorization Act gives the Air Force two ways to obtain approval of the lease: get specific authorization and appropriation language or get approval of a new start notification submitted as a reprogramming request.

need to grow from an average of $58 billion in FY2009 to $64 billion annually between 2010 and 2020 in 2004 dollars in order to fund its planned program.[3]

DOD might also face constraints on its total resources if the defense budget were to rise more modestly in later years. The FY2004 congressional budget resolution predicts that annual increases in spending on national defense will fall from the $20 billion to $10 billion or less beginning in FY2009. Although those estimates could well change in later years, pressures on defense spending could re-surface starting at the end of the decade with the retirement of the baby boom generation.

Second, the cost of the tanker lease program is uncertain. The total cost of the program could rise by $4.4 billion, from $24.6 billion to $29 billion in current year dollars if the Air Force decides to buy the planes as appears likely. Although the cost of DOD programs, and other government programs as well, often change over time, the Air Force proposal to lease rather than buy the planes appears to subject the government to the volatility of the bond markets. If interest rates for all three tranches of bonds to be sold on the market were to be higher or lower than anticipated, the cost of the program would change. An increase (or decrease) of .5 percent in interest rates would change costs by $400 million and a 1.5 percent increase (or decrease) would change the program's cost by about $1.3 billion. A straight purchase would not be affected by changes in interest rates. The Air Force also has not funded potential termination liabilities, which in 2011, at the height of the lease, could be $2.7 billion for the aircraft alone according to the Air Force's current estimates.[4]

Third, it is unclear whether the proposed lease complies with statutory and OMB requirements. To guard against agencies using operating leases to "buy on the installment plan," the government adopted guidelines that specify the types of arrangements that qualify as operating leases. Those rules are set out in OMS's Circular A–11 and reflect the 1997 Budget Enforcement Act. Some observers have questioned whether the proposed tanker lease complies with those rules.

Operating leases must be for commercial items with a private sector market. To support its case, the Air Force notes that the 767 was commercially developed and that Italy and Japan have bought several aerial refueling tankers and some other countries and commercial buyers have expressed interest. Critics of the lease argue that the Air Force variant would be substantially different from the commercial version (as indicated by both specific features and the difference in price) and suggest that the commercial market is likely to be small.

In order to distinguish operating leases from lease/purchases or capital leases, OMS's Circular A–11 Score keeping Guidelines also specify that in operating leases, the government is not to plan to transfer ownership or buy the asset shortly after the end of the lease.[5] The Air Force states that it would have to get authorization and appropriation of funds from Congress to buy the planes. DOD is committed to earmark an additional $2 billion in FY2008 and FY2009 to purchase the plane according to the Air Force's July 10, 2003 report to Congress.[6]

OMS's guidelines also specify that the lease is not to include a bargain price for later purchase so that the lease would be a way to buy the plane at a later point. The option price for the Air Force to buy the plane is about 15 percent below the price that the Air Force predicts the plane would command on the commercial market.[7]

To ensure that decision makers see the government obligations, OMS's scoring rules-for counting the budget authority for the program—are different for operating leases than for lease/purchases or a capital lease. The government's obligation in an operating lease is simply the annual payments whereas in a lease/purchase, OMB scores the government's obligations based on the value of the assets because the government plans to buy the asset at the end of the lease. In a capital lease, the full value of the government's obligations in present value terms is scored up front.

Using a special purpose entity (SPE) also makes it more difficult to have visibility on the government's obligations. According to a CBO report, other agencies who have relied on special purpose entities have launched programs without "scoring" or counting the full potential scope of the government's obligations. DOD, for exam-

[3] Congressional Budget Office, *The Long-Term Implications of Current Defense Plans: Summary Update for Fiscal Year 2004,* July 2003, p. 12.

[4] Air Force model 1, Business Case Analysis, July 2003. Termination liabilities could be substantially more if the support cost contract is included.

[5] 0MB, Circular A–11, Appendix A, *Scorekeeping Guidelines* (2002); these guidelines follow language in the conference report on the 1997 Budget Enforcement Act, H. Rept. 105–217, p. 1010–p. 1011, and are followed by both OMB and CBO.

[6] U.S. Air Force, *Report to the Congressional Defense Committees on KC767A Air Refueling Aircraft Multi-Year Lease Pilot Program,* July 10, 2003, p. A2–1.

[7] CRS calculation based on Air Force Modell, Business Case Analysis, July 2003.

ple, used a public/private venture to obtain about $2.3 billion in military housing while recording $255 million in obligations, almost a ten to one ratio.

For the proposed lease, an issue is: are the payments for the planes that the Trust makes to Boeing essentially governmentalobligations? The Air Force contends that the non-profit Wilmington Trust is a separate entity that will raise funds on the bond market to purchase the aircraft from Boeing and to receive lease payments from the Air Force to pay off those loans. Some observers, however, have suggested that Wilmington Trust is basically a conduit for the Air Force, or essentially an extension ofthe government. Under OMB's *new* guidelines issued in July after the Air Force submitted its lease proposal, it appears that the Wilmington Trust could be considered a governmental entity and the buy ofthe aircraft be scored as an Air Force obligation, with far larger budget requirements than annual lease payments.

Fourth, and in conclusion, it is not clear that this lease is a good deal for the government. Some observers have questioned whether the proposed lease is a good deal for the government—either compared to a multiyear purchase of the aircraft or as a lease. GAO and others have raised concerns about the lack of competition for both the $17 billion lease and the $8 billion in support costs, much of which would also go to Boeing.

Compared to a multiyear buy, is the lease a good deal for the government in current year dollars? CRS estimates that a lease would cost $21.1 billion, $5.7 billion or 27 percent more than an operating lease that was followed by a buy of the aircraft at the end of the lease.[8]

If the Air Force were to spend those funds on aircraft rather than relying on an operating lease in order to pay less in earlier years, those dollars would purchase about 35 more tankers.

As a lease, it appears that the Air Force's price may be questioned as being above commercial rates especially in light of today's oversupply of commercial aircraft. Based on a formula for commercial leases presented by John Plueger, CEO of the International Lease Finance Corporation,a commercial airliner operating lease company,the cost ofthe Air Force six-year lease would be expected to range from $59 million to $95 million per aircraft or about 35 percent to 57 percent of the value of the aircraft. The Air Force's lease, however, is estimated to be about $166 million in current year dollars or about 90 percent of its market value.[9]

Why is the Air Force's price so much higher than might be expected? The price of the lease appears to be designed to minimize the amount of the loan that would be outstanding at the end of the lease, and hence the riskiest funds to borrow, an Air Force concern. OMS's guidelines cap that level at 90 percent of the value of the aircraft. Bondholders who finance that last 10 percent of the value of the aircraft will only be paid when and if the Air Force buys the plane. Because the decision about that final purchase has not been made and depends on congressional action, the Air Force believes that those bonds would require a high interef?t rate of about 10 percent. The Air Force leasing price is intended to minimize the amount of funds that would require that high rate.

Mr. Chairman, distinguished members of the Committee,this concludes my testimony, and I look forward to addressing any questions that you may have.

The CHAIRMAN. Thank you very much, Mr. Bolkom. Mr. Holtz-Eakin, Mr. Bolkom says this deal is unusual if not unprecedented. Do you agree with that?

Mr. HOLTZ-EAKIN. Yes, we would concur.

The CHAIRMAN. Mr. Curtin?

Mr. CURTIN. Yes. I'm not aware of anything quite like this.

The CHAIRMAN. Secretary Roche, why wasn't a formal analysis of alternatives conducted on this lease purchase?

Secretary ROCHE. Mr. Chairman, as you know, there's no requirement to do a formal analysis of alternatives. It's a regulatory thing, and there are examples of other programs where this was not done, for instance in the KC–10 acquisition it was not done,

[8] CRS calculations based on Air Force Modell, Business Case Analysis, July 2003.

[9] CRS calculations based on testimony by John Plueger before the House Armed Services Committee, July 23, 2003, and CRS calculations based on Air Force Briefing to CRS, "KC767A Report to Congress, Status Brief," July 15, 2003.

and there are some others, F18–EF was not done, C–103J. There was a discussion of this held by——

The CHAIRMAN. The F18–EF and the KC–130J were existing aircraft, they were just later models.

Secretary ROCHE. Yes, sir, I think we would agree that the F18–EF is a remarkably or dramatically larger aircraft containing lots of new electronics and other things.

Mr. CURTIN. My question is, why wasn't an AOA conducted on an issue of this magnitude and this amount of money?

Secretary ROCHE. A discussion was conducted, sir, in the Pentagon with the head of ATNL, the acquisition executive, people from PANE, deputy secretary, service chiefs, service secretaries, going through this particular case, recognizing that it has to be a large airplane and recognizing there are only two manufacturers in the world we could really turn to. But yet we did look at re-engining. We did look at purchasing a plane from Airbus.

We did look at used planes that might be available and we also looked at what might be involved in developing a new plane, Mr. Chairman, and felt that there was not a reason to spend the time to do that.

The CHAIRMAN. You are aware that the Office of the Inspector General says an AOA should have been conducted?

Secretary ROCHE. Yes, sir, I understand that's his opinion. The Under Secretary of Defense

The CHAIRMAN. It's not just his opinion. He's the Inspector General of the——

Secretary ROCHE. Yes, sir. With all due respect, Mr. Chairman——

The CHAIRMAN. It's more than just a matter of opinion. Why wasn't the IDA that was conducted, why wasn't that—their recommendations and objections taken into consideration?

Secretary ROCHE. They were, Senator, Mr. Chairman. We had a lot of people who have spent time on this for the last year and a half. There was lots of debate. When all was said and done, the Office of the Secretary of Defense, the Under Secretary of Defense for Acquisition approved the process, approved this lease going forward. It then went over to the Office of Management and Budget. They also approved it. In the course of that, there was much debate on both sides as to does this better discount rate, should you think of this as the model of acquiring, et cetera.

The CHAIRMAN. But Mr. Secretary, the Institute for Defense Analysis said that the lease should be $120.7 million that, quote, should satisfy Boeing and its shareholders. They didn't change their position on that.

Secretary ROCHE. No, sir, they didn't, but there was a debate as to whether that was going to be an aircraft delivered that was fully FAA certified. And in fact it's one thing to ask people for a rough order of magnitude instead of numbers, it's another thing to have a firm, fixed price, which this lease provides the taxpayers, a firm, fixed price with the exception as noted of interest rates. But in terms of everything else, there's no way we could have an overrun on this program, sir.

The CHAIRMAN. Was there ever a formal study of the corrosion problems on the KC–135 conducted?

Secretary ROCHE. There have been a series of studies done in the Air Force material command, not one that specifically stopped and said, let's look at all the KC–135s and see the degree of corrosion. There have been data that have been building. There's also data now available——

The CHAIRMAN. Why we wouldn't do such a thing?

Secretary ROCHE. —on our 707s that were refurbished and are back in service and in fact recognizing they do not act like brand-new airplanes but act like middle-aged airplanes.

The CHAIRMAN. Why do we need a FAA-certified airplane?

Secretary ROCHE. A tanker has to be an FAA-certified airplane, sir, because it goes to lots of airfields around the world in many countries, it flies around the United States. It's the same reason we can't fly certain drones over parts of the United States because they're not FAA certified.

The CHAIRMAN. Do you believe it's appropriate to tell Boeing what the offer of the Airbus was? Do you believe that's appropriate?

Secretary ROCHE. Sir, debriefing each party after a competition or request is appropriate. The use of specific numbers may well not have been appropriate and if it is proprietary information, it was absolutely inappropriate and that's being looked into.

The CHAIRMAN. How do you respond to the three witnesses who we in Congress—represent agencies that we in Congress rely on for objective information to provide us with recommendations as to how we should conduct our business particularly in the area of procurement?

Secretary ROCHE. Senator, it's an absolutely appropriate question. My sense is we have been through so many groups who have looked at this, who have been spent so much time on it, it is very complex, it does very much hinge on the type of assumptions you make, as have been noted. My colleagues here at the table have been very good to point out that if you have a different model for how you purchase, it'll make things swing in very different directions, including swing more favorable towards lease and to certain circumstances. So a lot of it is assumptions. That's why when this all came up and recognizing its complexity, I gave my word to you, Senator, that we would not move forward unless the authorizing committees also agreed and gave everyone a chance to take a look at this to make sure.

The CHAIRMAN. Finally, Mr. Secretary, according to recent report, you said that you have not completed your negotiations with Boeing and that we're battling this for a while, in other words, have you concluded your negotiations yet with Boeing?

Secretary ROCHE. No, sir. On the particular items that you're referring to, I can tell you that——

The CHAIRMAN. Just answer my question. You have not completed your negotiations with Boeing?

Secretary ROCHE. No, sir. They've made a lot of progress today, Senator.

The CHAIRMAN. So what you want Congress—three Committees of Congress to approve of a lease that we haven't even seen, that you haven't even finished the details of. Remarkable.

Secretary ROCHE. If I may, Senator, may I?

The CHAIRMAN. Sure.

Secretary ROCHE. Mr. Chairman, when we typically get an authorization and appropriation, we don't have a final contract that we bring forward for a committee to look at. We have a lot of professionals——

The CHAIRMAN. When we purchase something, we know the full purchase price though.

Secretary ROCHE. Senator, quite often we have estimates, and that's why there have been so many program overruns that heaven knows I've lived with. One of the attractive features of this is they're not.

The CHAIRMAN. We know what the terms of the contract are, Mr. Roche.

Secretary ROCHE. Usually, sir, quite often there are not the specific terms and conditions negotiated at the time of an appropriation. There's an amount of money and there's a model contract. We've sent forward the draft here——

The CHAIRMAN. It's a contract, Mr. Roche. I've been around here a long time.

Secretary ROCHE. Sir, also in this particular case we would not go forward until this was looked at by the Office of the Secretary of Defense and the Office of Management and Budget again.

The CHAIRMAN. But you expect Congress to approve of a deal that you haven't even completed? Let's see, Senator Inouye.

STATEMENT OF HON. DANIEL K. INOUYE, U.S. SENATOR FROM HAWAII

Senator INOUYE. Thank you very much. Mr. Chairman, at the time this arrangement was made I was Chairman of the Subcommittee, so I do have some interest in this matter. Is the KC–135 capable of being refueled in the air?

Secretary ROCHE. With very few exceptions, no sir.

Senator INOUYE. Can the 767 be refueled in the air?

Secretary ROCHE. Yes, sir, we have learned from the KC–10 the value of being able to consolidate. If a gallon of gas costs roughly $1.50, when we price out what does it cost to transfer from a tanker to a jet that's over a combat area, it's closer to $17 per gallon. We waste a lot of money by bringing back fuel all the way back to refuel and take it back as compared to being able to consolidate. One of the great advantages of the KC–10 has been consolidation. It would be part of every one of these planes.

Senator INOUYE. In Afghanistan and in Iraq there were three types of aircraft, the Air Force, Navy, and Marine Corps.

Secretary ROCHE. Plus coalition, sir.

Senator INOUYE. Can the KC–135E refuel all three?

Secretary ROCHE. Not more than one type per flight. In other words, you'd have to change from either a probe or excuse me, a boom to a probe and drone. You could not have one mission and be able to handle two types of airplanes because one of the operational savings we see coming is if we had a mix of Navy aircraft and Air Force aircraft in a cap station and we had to maintain that cap station, today it would take us three KC–135Es to do that or one KC–767, primarily because of the increased fuel and the ability to fuel two different types of airplanes on the same mission.

Senator INOUYE. Would that have made a difference if we had it?

Secretary ROCHE. It would have, sir. We had enough aircraft in this last conflict that we were able to handle everything, but if we had not had the KC–10s we would have been in very deep hurt, because the KC–10s were one of the primary aircraft to refuel Navy and Marine Corps aircraft.

Senator INOUYE. One of the requirements that you specified for the 767 is that it had to be upgraded as a smart tanker. What do you mean by that?

Secretary ROCHE. No monies are being spent on that. The idea is over time we would like to use the presence of a tanker, and there are many of them, to be able to add electronic palettes. So for instance we have a test that has completed that we are very much impressed by wherein we can roll a palette on board and create a radio relay system in an area without having to overuse satellites, so that we are able to have a local area network in effect, and that is the sort of a think of a smart tanker, using a tanker for more than just passing fuel, but while it's there having it do other things. In time, we believe we can put passive apertures on it and have those apertures communicate to something like a river joint aircraft for electronic warfare and be able to make use of the fact that we have these aircraft in the area to provide virtual antennas that are very large.

Senator INOUYE. Can the KC–135E do that?

Secretary ROCHE. No, sir, none of them can. We could modify that but we don't quite have the real estate on the KC–135E. The communications palette does fit on an E or an R model.

Senator INOUYE. Is there any difference between the operating costs for 767 and 135E?

Secretary ROCHE. If you take maintenance and everything into account, there are, Senator. I'm afraid it's not on the tip of my head. May I get back to you specifically on that? One of the features that we have put into this is because of the low emission capable rate overall, including aircraft and depo, that the requirement for the 767, and one of the reasons why we've done the logistic support with the contractor to begin with, eventually this will transfer to a partnership with one of our ALCs, is to specify an 80 percent mission-capable rate, which includes all aircraft whether they're in depo or not. But at any given time four-fifths of all the aircraft must be available.

In the case of the KC–10 we used contractor logistic support and it had the highest proportionate usage rate of any of the tankers. In other words, we only have available at any given time 53 of the 59 because the others are used for schools, but we used 42 of that 53 throughout this OIF. That was much higher than anything else. In the R models, it was less than half, and in the case of the E models it was 36 out of 131. So the idea of having a specified goal for a contractor logistic support has proven itself in the case of the KC–10, and we also use it in the C–17, sir.

Senator INOUYE. This afternoon many numbers have been mentioned, $1.9 billion, $150 million, $130 million, et cetera, et cetera. In the dollar figures that we've been told, do you believe that factors such as re-engining, corrosion, upgrading, have they been factored in?

Secretary ROCHE. They've not been factored in the side-by-side analysis, the overall sense of urgency to move forward, yes. This begins from many different sources, in my case from going to Tinker air logistics command in July 2001 and being quite shocked by the degree of catalytic corrosion, which is a battery effect of moisture and dissimilar metals, and then doing homework on what has happened to the 707s that we're using for Joint Stars that we've invested to bring to a current condition and how do they behave. They don't behave like brand-new aircraft. Therefore the sense that this is going on and at the same time after 9/11 the demand on these type of aircraft suggested that across the Air Force this was a much higher priority than it had been treated as in the past. I very much agree with the Chairman that in the past this was not treated with the degree of priority that I believe it should have been.

Senator INOUYE. In your mind as the Secretary of the Air Force, do you think that the taxpayer is being shortchanged?

Secretary ROCHE. No, sir, I made it clear that I would not come back unless I felt this was a good deal for the American taxpayers including having these aircraft in the hands of warriors earlier, including being able to get the operational savings by having more efficient and effective aircraft in place, and that's why we have tried to be as transparent with all of the staffs, and in a year and a half of intense debate, I believe we've all come to closure on something that makes sense, and I believe it does make sense, yes, sir.

Senator INOUYE. In February of 2002, did the Air Force issue a request for information to both Boeing and Airbus?

Secretary ROCHE. Yes, sir, we did.

Senator INOUYE. What was the outcome?

Secretary ROCHE. The outcome was a comparison of the Airbus A–330, as I recall, the 767 as compared to the KC–135, and the KC–10. And the primary factors were not costs because in fact the Boeing plane initially was priced much higher, but that the size of the Airbus plane, the A–330 was a very, very large footprint, yet as you can go on the Internet and look up, it's long with very long wings which means it has a spotting factor that's very high but doesn't carry that much fuel proportionate to the fact that spotting factor is in fact bigger than a KC–10, whereas a KC–767 is only slightly, about 25 percent larger than a 707 or KC–135 and has greater throughput in all but one scenario.

The CHAIRMAN. Senator Stevens?

Senator STEVENS. Thank you very much. Secretary Roche, one of the factors that was involved in the guidelines that CBO used, Mr. Holtz-Eakin might want to comment after your answer, but I understand was whether there was a private sector market existing for these planes. It's my understanding that the State Department has offered guidelines for commercial sales of 767, the Italian Government has selected it for tanker missions and has purchased four aircraft, the Japanese have committed to buy four aircraft, the British have issued requests for proposals. Have you come to conclusion as to whether or not there is a private sector market existing as far as these planes are concerned?

Secretary ROCHE. Senator, on two levels, one, there are countries who have observed the United States' ability to project its power by virtue of tanker aircraft and that they are asking and showing interest in this particular aircraft. Second, it's also a very good lifter. It has had a very good cargo capacity, so one could use it as a cargo aircraft as well, because in any of these like the KC–10s, which I'm sure you've been on, there's a lot of space inside that if you put less fuel for refueling you can use for cargo.

Senator STEVENS. I was going to ask a second question about that. I understand that the current aircraft configuration has been changed substantially, that it now includes an advanced flight deck, convertible cargo passenger interior, increased power generation, and substantial other features. Was that important in connection with the negotiation as far as this aircraft is concerned?

Secretary ROCHE. Yes, sir, it increases the cost. We took away some of the features we had originally put in when we took a second look to try to have a lower price and felt for instance that you don't need a 4-hour turnaround, that you paid a lot of money to be able to have something that could convert very, very quickly between passengers and cargo, and so we tried to reduce that. That accounted for about $3 million per copy, but the fact that the plane is very agile means that if were to, for instance, have to escort a series of Marine Corps aircraft from Cherry Point to Japan, we would do it with these airplanes with half the use of fuel than we otherwise would because the tankers themselves can carry the cargo that normally you have to assign to a cargo aircraft, as well as being more efficient, so it's a one-half savings.

That's one of the operational savings that we point to. We didn't factor those into the analysis because it's hard to say how often will you do that, how much will you be at war, et cetera. Our larger concern was that if we look from July 2002 forward, we could not have predicted the Afghan conflict in the next two years nor the Iraqi conflict, but we could predict that the tanker aircraft were aging. Once these things occurred, 9/11 occurred, and that even as we speak, Senator, there are a number of tankers that are on alert around the United States plus the missions overseas, the demand on these was growing and it seemed sensible to hedge, especially since years ago when the tanker fleet was only 17 years old both the Congress and the administration of both parties agreed a hedge made sense. I think it makes even greater sense and the 100 airplanes would do that.

Senator STEVENS. These 100 airplanes will replace at least 131 of the old ones that are going to be retired, right?

Secretary ROCHE. Yes, sir.

Senator STEVENS. In terms of the operational capability, have you compared those 100 to the others that will not be retired?

Secretary ROCHE. Yes, sir. We've compared them in terms of how the KC–767 would compare to the 767s and in all it's better than the E model in every case. In the case of the R model, there's one condition where you have to take off and fly 3,500 miles before you refuel an airplane and there it's slightly worse than an R model for reasons of just fuel consumption. Generally it's better across the board, and if we were to recapitalize beginning now, we will still have R models of the KC–135 flying when they're in their seventies, so it's not that all the 544 will retire, even though their average age is 43 years, because some of these are going to have to last in their seventies, and we expect the cost of that maintenance to be quite high.

Senator STEVENS. Part of this conundrum is the availability of budget authority for the future in replacing all of these planes at the same time as we're going into other problems that you face in terms of the joint strike fighter, the F–22, and all those other planes that have substantial byways ahead of them. Do the considerations of the budget process enter into your decision?

Secretary ROCHE. Yes, sir, absolutely. We were asked and pressed by the staffs and the Defense Department, could we afford to pay all of this and have our other programs as well? There are a number of programs which start to come down about the time that the demand for increases in this program go up, the FA–22 starts to come down, the C–17 starts to come down, and our sense, and as we demonstrated to the Department of Defense is, we can handle this under not heroic budget projections but rather flat-line budget projections for the future, that it could be done, yes, sir.

Senator STEVENS. Provided we have the budget authority at that time, the time of the transition?

Secretary ROCHE. Yes, sir. The difference is now, it's clear if we were to try and move this to a purchase now there is not the budget authority available without causing severe harm to ourselves or our sister services.

Senator STEVENS. It may interest everyone to know that our Appropriations Committee is the only Committee in Congress that is subject to the Budget Act really in terms of the limitations on budget authority and outlays. My colleague reminds me of that from time to time, but I personally believe still this is in the best interest of the country to move forward and get these planes as quickly as possible. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, sir. I'm told there's no requirement for FAA certification for military aircraft that's being operated by the military and for the military to fly into any airport or any commercial airport. I'll guess we'll have to find out which one of us.

Secretary ROCHE. Yes, sir, I'll be glad to get back to you.

The CHAIRMAN. I certainly flew aircraft, Mr. Secretary, into airports that were not FAA certified, my own experience. Senator Cantwell?

Secretary ROCHE. Senator, may I get back to you with that sir?

The CHAIRMAN. We'll supply for the record. Senator Cantwell?

Senator CANTWELL. Thank you, Mr. Chairman. Secretary Roche, you were just now making a comparison to if you wanted to get more KC–135s to the 767, but obviously getting more KC–135s isn't really an option, correct?

Secretary ROCHE. No, ma'am. Those are long since out of production and the spare parts for them are long since out of production except for in small amounts.

Senator CANTWELL. So you're making a good point about the difference in the new model and its increased capacity but I just wanted to point that out for people that you can go back to the KC in fact, wouldn't you say that one of the great benefits of this proposal is that we are getting the engineering and production costs that I think even by CBO's estimate that designing and building a new tanker would probably cost more and take longer if we didn't have the 767 as the model to go from, isn't that correct?

Secretary ROCHE. Yes, ma'am, that's the parallel to the KC–10, wherein the taxpayer can benefit from commercial investment over many years and pick up a plane as it's near its commercial life in terms of new production. However, the infrastructure around the world, the spare parts, the inventories, the people who know how to maintain them are still very much around.

Senator CANTWELL. I'm not sure that any of these many, many models and assumptions are taking that into consideration, are they, other than just the overall net effect of it?

Secretary ROCHE. No, ma'am. We had to approach the rules from OMB in terms of a purchase versus lease very specifically and a number of these were set to the side. I believe they add to the reason why I think this is a good thing to do.

Senator CANTWELL. The apples and apples comparison that was thrown out to net present value, you sort of answered this question but not in great detail. Why is a net present value today in an outright procurement why isn't that possible?

Secretary ROCHE. I'm sorry, ma'am, why we couldn't procure it immediately?

Senator CANTWELL. Yes.

Secretary ROCHE. Because we simply don't have the budget authority to do that and also our rules that we have to follow would have us go through a development program, we pay all the development costs up front, and then even as the Inspector General notes, who would like to see us have a prototype, learn that, that's all time. Time is money and that means we'd be living on the same existing fleet for even longer. We're not sure of what a 767 might cost if it was not leased in terms of asking a line to stay warm, if the line ran out, or if it might just run out, it's a commercial company, it can make decisions based on its shareholders' needs.

Senator CANTWELL. Isn't that part of the reason why maybe the decision had been delayed or prolonged before, because of the huge cost of an out-and-out procurement?

Secretary ROCHE. I think, yes ma'am, in the case of the, up until the year 2001, the budget in the Pentagon was down, there were a number of conflicting priorities, we have found examples where the Congress for instance discovered how little attention was being paid to spare parts, and even prior to the election of this Administration did a lot to start putting money toward spare parts to get mission capability rates up. There was an expression called buying-down readiness which was to in fact defer readiness, not put in parts, so as to free up monies to procure because the procurement budget was so low, and I think the tankers viewed of what the missions expected for them were not viewed as an important priority item. I think the world has changed, and I believe that they are a very high priority item now.

Senator CANTWELL. On that point——

Secretary ROCHE. At least to hedge against the fleet.

Senator CANTWELL. —on that point that the world has changed, two of your co-panelists are Mr. Curtin, who had admitted the GAO issued a report before saying we have a big problem coming at us and may have a huge bow wave of maintenance costs, and Mr. Bolkcom also mentioned what's changed in the last couple of years. They both mentioned not sure enough has happened or the risk assessment of what the next several years would be like. Could you elaborate on that because it seems clear to me in all the things that have happened in the last couple of years that the increase in sorties must be dramatic and the projection about increased sorties is not slowing down any time soon. So if the Air Force hasn't made that clear, there seems to be a disconnect why that perspective isn't more certain as to the increase in demand?

I'm asking Secretary Roche if you would comment on what that actual increase in demand of sorties are because I say you have two panelists who are following this and aren't quite clear, haven't heard that message and are saying, yes, we believe the need is there for new 767, for the new tanker, but we're not sure what's transpired in the last couple years. I'm asking you to further explain what's transpired.

Secretary ROCHE. Thank you, ma'am. I didn't realize that was directed towards me. The planning models that we used in the Department of Defense up until 2001, this Administration, were basically two major wars and that's all and a lot of the planning went for that. Our AWACs for instance are based on that, but the reality of life is we're in many more places at the same time. There was a point in time when a conflict in Afghanistan was viewed as one of the most stressing and we'd probably never do it because it's a landlocked country, that from the shore to the beginning of Afghanistan is 300 and some miles. Therefore, it's not the sort of normal place you would ever want to have a conflict in.

There was not the plan to be able to have a lot going on at the same time and it turns out they're all far away and they all place great demands on aircraft, not just Air Force aircraft, but naval aircraft, as well as Marine Corps aircraft, and for a Navy plane to take off in the north Indian Ocean and fly into Afghanistan requires land-based tankers in addition to its own indigenous tankers on board the carrier which are very small, but once you get over land and get going, you need land-based tankers. That was a demand we had not seen and a demand I did not believe that was forecasted.

Noble Eagle was obviously never forecasted, the fact that we have to have multiples of tankers available and on alert filled in any given day to be able to service aircraft overhead here. There are a number of other cases where the tankers were planned at a much reduced rate of usage and that's gone up because we are flying in these other places, I said of 69,000 sorties, we have almost as many tanker sorties as we have Air Force fighter bomber sorties.

Senator CANTWELL. And do you have a number on the percentage of increase that we've seen?

Secretary ROCHE. I don't have the percentages in my head, ma'am, but we can get back to you for that.

Senator CANTWELL. Thank you.

The CHAIRMAN. Senator Fitzgerald?

Senator FITZGERALD. Thank you, Mr. Chairman. Secretary, I did want to go back to the issue I raised in my opening statement. As

I said, I think it's clear, everybody who testified here today said we'd save more money if this were a straight-up purchase. I noticed that the public law that authorized the Air Force to enter into a lease did not authorize you to enter into a purchase, it only gave you one option to enter into a lease.

If Congress were to give you the budget authority and perhaps help you cut some of the red tape out of the DOD procurement process, wouldn't you agree it would preferable to buy these tankers and save the $6 billion for the taxpayers? Don't you have something else you could do with that $6 billion?

Secretary ROCHE. Instinctively Senator, may I make two points. The notion of net present values compares streams of outputs over time. It is exactly as one of my colleagues pointed out, how much money do you have to put into a bank earning at a rate that is acceptable such that you can meet the need payments over time? A lease pushes the payments out, therefore dollars are worth less than current dollars. The purchase model we used, the classic model, if we were to have a situation which for instance yields something like the $1.9 billion difference of where A, the money was available up front without our having to go after other programs recognizing we've gone 12 years with very little procurement, and the rules were changed so that it was not development money and production money, that it was the same ability to blend those and to order 100 of something at a time as compared to a lot smaller, and you are able to amortize over the course of all of the aircraft, a lot of these if-if-ifs, which now are not permitted and would be a major change to our normal procurement rules, then the purchase starts to look much much more attractive.

There's just no press for that, nor would we expect that to occur. The lease I believe is a one-time opportunity to get a jump start to recapitalization, but it's not something you would do for the rest of the force.

The CHAIRMAN. Senator Fitzgerald, maybe Mr. Holtz-Eakin and Mr. Curtin might have a comment on that rather bizarre answer.

Mr. HOLTZ-EAKIN. Let me try to make clear the nature of the CBO analysis so as to alleviate any confusion about alternative models and the importance of net present values. The first point is that the decision to use 767s instead of the existing tankers is a policy decision. Our analysis compares alternative means by which the same 100 planes would be acquired by the U.S. government on exactly the same schedule, and in each case Boeing would receive these same $131 million per plane. Our first point is simply that these ought to be reflected on the budget because this special purpose entity is in fact an instrument of the government.

Senator FITZGERALD. So you're saying even if we do enter into the proposed arrangement, that it should be reflected in our budget because, and you're saying that because really the government is going to control this trust and it really is an acquisition.

Mr. HOLTZ-EAKIN. Yes.

Senator FITZGERALD. It is an acquisition. It's just a complex legal construct to evade the DOC procurement requirements, isn't that correct, Secretary?

Secretary ROCHE. Senator, there's certainly no intent to evade. That's why we have made this transparent to everyone, so there's no intent to evade at all.

Senator FITZGERALD. Congress is authorizing you to evade.

Secretary ROCHE. The special entity does own the aircraft. The title to the aircraft is not in the Air Force, it's in the special entity.

Senator FITZGERALD. Who's the trustee of the special entity?

Secretary ROCHE. The Air Force, but——

Senator FITZGERALD. Okay, that means you're the legal title holder.

Secretary ROCHE. —no, sir, they are, under Delaware law they can recover the airplanes and they can sell the airplanes at the end of the lease. The only provisions we have are the price of the airplane at that time.

Senator FITZGERALD. The legal title holder of the property is the trustee of the trust. You are both the lessor and the lessee under this. It's not a lease, it's just a complex legal construct to help you avoid the procurement laws that we have around here, and I'm very troubled by that.

You know, we're going to have this Iraq supplemental very soon, it's going to authorize emergency spending without budgetary authority, and based on the Air Force argument of urgency, I would think that this deal would have much more merit for emergency spending than the non-emergency projects and earmarks that I'm sure are going to be thrown into this so-called emergency supplemental. Why not do this straight up and go through the ordinary process? This is a way by going on with the supplemental you could avoid the problem with budget authority that you are so concerned about.

Secretary ROCHE. From my position, I want to hedge the airplanes. How those airplanes are obtained is secondary to me.

Senator FITZGERALD. Do you not care about the $6 billion it's going to cost extra that it's going to cost the taxpayers? It's coming out of people's paychecks?

Secretary ROCHE. Sir, I do, but in net present value terms, it is not that amount. It's the time value of money and when the time value of money is put next to the purchase or lease, it's $1.5 million per plane, as we propose it, as the Office of the Secretary of Defense argued and manipulated, and as OMB approved it.

The arguments my colleagues have to the left are not just with the Air Force. We've had lots of people in this for the last year and a half. It is not taking money from the taxpayer, it is the time value of money as it's spent over various years, but my interest is to hedge and the fastest way that I now how to hedge is with this lease. If there were a way to do this comparably with a purchase under a number of these assumptions which have not been available in the past, then certainly if I could get the airplanes more quickly I'd feel I'd be fulfilling my duties to the Secretary of Defense to ensure that he's able to make use of forces when he has to for the President.

Senator FITZGERALD. May I ask well, I've——

The CHAIRMAN. Senator Lautenberg?

Senator FITZGERALD. Thank you, Mr. Secretary.

Senator LAUTENBERG. Thanks, Mr. Chairman. We're obviously somewhat perplexed. It's not to say that those who are raising the questions fair that we don't believe that this refurbishing, this newer approach ought to be followed. The question is, why is it that we can so easily explain away a savings of $6 billion. I would vote right now if you said we want to buy these ignoring for the moment the process, I'd say yeah, fine, let's buy them. It's not that I don't want them to have the best capability for fueling or cargo or what have you, and so when I look at this and I see that we're looking at a savings of maybe $400 million a year if we buy them, that we're told that we can't get delivery at a sooner time if we buy than if we lease, which is certainly a reasonable question.

Why if they're going to start to be available in 2005, what does it matter whether we lease it or we buy it and we're paying a heck of a price if you're saying, well, okay, the danger is imminent but we can't do the transaction the same way whether we're willing to commit, we do often commit to long-term proposals when we buy an aircraft carrier, they don't deliver next year, we make a commitment to buy it of pay for it over the years as it's built.

So Mr. Roche, I've got to confess and I come out of a fairly complicated business environment that I just don't get it, and I heard your explanation. Are we really saying, and I think Senator Fitzgerald kind of asked the same question, are we really saying that if you want to get around the red tape, here's a way to do it? Well, I think we ought to look at the tape instead of just tossing away $5.6 billion. That kind of money would buy us a lot right now. We need a lot more in the military than we thought we'd need if we look back just a couple years, so I say figure out a way and some of us here would be happy to carry the burden of trying to get a reauthorization or whatever else we need to get this purchase on the books, and why can't the delivery schedules be the same whether you buy it or you lease it?

Secretary ROCHE. Under the laws and rules we follow, we would have to go through the normal process unless that process were changed. If the process is changed, then it's a different set of circumstances we would look at. We have no indication that that process could be changed, nor do we have an indication, Senator, that the monies, the budget authority would in fact be available. Had, and I agree very much with the Chairman, had earlier in the 1990s this been thought of and a systematic way to deal with this put in place, we wouldn't face the situation we face of very old airplanes that are only getting older with the prospect of taking a long time to replace them.

Senator LAUTENBERG. But are they able to supply our needs for conflict now?

Secretary ROCHE. So far they have, yes, sir. The issue as raised by again one of my colleagues here is, we couldn't predict the world in 2001, in July of what really happened within 24 months. I find the same situation, I can't predict what the next 24 months will be like, nor can I predict how these aircraft may behave because they are now so old we've never had aircraft like this, we've never had a fleet this age.

Senator LAUTENBERG. Do we want to predict what wars will look like three years from now and vary our procurement based on that?

Secretary ROCHE. I think in many respects, Senator, that Secretary Rumsfeld is directing the services to think about what is the more likely type of war and one feature that comes across a lot is they're far away.

Senator LAUTENBERG. Well, they are far away and I don't know that we can make changes very quickly about bringing them closer but——

[Laughter.]

Secretary ROCHE. I don't think we'd want to, Senator.

Senator LAUTENBERG. No.

Secretary ROCHE. I meant far away in distance, not time.

Senator LAUTENBERG. So maybe what we ought to do is get a couple more aircraft carriers, I don't know what the cost of these things are. But the fact is I think that dismissing the inability to predict what the future might be shouldn't cause us to go ahead, throw out $6 billion, $5.6 billion of the public's money and rush this through on a lease deal which frankly doesn't seem to make sense. If we need a change that we can save the taxpayer $5.6 billion over the next 14 years, less than 14 years, I'd say, hey, let's work on the changes. Would you endorse the purchase of this if the changes could be made to allow you to do the purchasing that way?

Secretary ROCHE. Senator, if in fact all things could occur such that these planes could get there at the same rate they could with the lease by another means, I'd be delighted to take a look at that other means.

Senator LAUTENBERG. Well, then why do we fall to the easy way and spend $6 billion?

Secretary ROCHE. Granted there'll be a debate in terms of assumptions, but the value of doing net present value is, if you have an assumption of a model of purchase, a model of lease, and you bring it back to the same time, it's a way of reflecting that. My colleagues differ with what we have done and what the Office of the Secretary of Defense has done and OMB basically on what the assumptions of those models are. And it's I can't say they're wrong, all I can say is enough people who have reviewed ours and have made changes to it are now willing to go forward.

The CHAIRMAN. Senator Sununu?

Senator SUNUNU. Thank you, Mr. Chairman. It seems to me there are several questions here. First is the question of need, and I think Mr. Holtz-Eakin indicated this is a policy question, and as someone who was fortunate to fly on a 135 with a great National Guard refueling wing that flies out of New Hampshire, I will stipulate that I've never felt safer and at the same time I'm sure that they would love to fly newer planes. They do a great job, they love their work, they're dedicated to their country, but I'm sure that wing would love to have new planes. But let us at least agree or go on the assumption that there is a need based on age, based on a natural cycle of upgrading, let's stipulate at least for the time being that there's a need.

The second question would be savings and the term $6 billion is thrown around the Secretary points out, well, that's not really fair, you should look at net present value, fine. And if we're looking at gross savings, savings today that are looked at over the series of payments here, net present value is the way to look at it and we can argue whether the savings by purchasing is $500 million or $1 billion or $1.3 billion or $1.9 billion, but I think everyone including the Air Force has argued that there are savings with the purchase option versus a leasing option. Then you get to the third question, which is scoring, and I'm sorry to be the one to bore everyone with scoring, but that's really the defense that you're falling back on at least as far as defending the way that you're approaching this, Mr. Secretary, and that is, well, you have issues of payment streams based on purchasing versus payment streams and budget authority versus leasing. So I want to delve a little bit into these scoring issues. I assume this is a CBO document, is that correct?

Mr. HOLTZ-EAKIN. It's part of our report.

Senator LAUTENBERG. Okay, this is the CBO document, this is the scoring, the CBO scoring that we all have to live by, love them or hate them, and I will put my side on the side of usually defending the CBO, but we've got scoring here for three different transactions, one is a purchase, one is an operating lease, and one is a purchase lease, is that correct?

Mr. HOLTZ-EAKIN. That's correct.

Senator LAUTENBERG. Okay. Are all three of these the same schedule for receiving airplanes?

Mr. HOLTZ-EAKIN. The same 100 planes on the same schedule.

Senator LAUTENBERG. Same 100 planes, and based on that schedule of receiving, obviously the deferred maintenance costs that Senator Stevens raised, it would be the same for all, we're protecting ourselves against increased maintenance costs over the same period of time, is that correct?

Mr. HOLTZ-EAKIN. That's exactly right.

Senator LAUTENBERG. So the real question is which one of these scoring models do we have to or wish to use or I guess I'll emphasize the have to use over time, and one is the purchase, the other is the lease purchase, and the third is the operating lease. Now, Mr. Holtz-Eakin, is it your contention that you have to use by law the lease purchase as opposed to the operating lease model?

Mr. HOLTZ-EAKIN. That's exactly right. Of the three panels shown here, only two are really choices. These transactions should be on the budget and if treated consistently with OMB guidelines, they will be treated as a lease purchase, the top panel, which has the——

Senator LAUTENBERG. And that's because of this six-part test, is that right?

Mr. HOLTZ-EAKIN. Yes, it's a six-part test.

Senator LAUTENBERG. I want to go into a little detail on this six-part test. Senator Fitzgerald raised the issue, I think it was that ownership of the asset much remain with the lessor and we got into an argument of who's really having title to these planes. I'll give the Air Force that one. I'm willing to give them this one. The ones that stick out in my mind is first, the lease must be for a general purpose asset, operating leases must be for general purpose asset, not one that's built to unique specifications of the government. Now it would seem to me that an Air Force military refueling tanker is specifications, specific requirements of the Federal Government, would you agree?

Mr. HOLTZ-EAKIN. As detailed in the report, that's exactly what we believe.

Senator LAUTENBERG. Secretary, you would disagree with that?

Secretary ROCHE. Disagree, sir, because we in fact, as we did with the KC–10, we take an existing plane and try to make——

Senator LAUTENBERG. So these planes won't be built to the government specifications?

Secretary ROCHE. There will be a commercial plane and then there'll be modifications made. Now certainly the boom and the probe-and-drogue are military, that's absolutely right, and any cryptologic equipment or other source of communications equipment——

Senator LAUTENBERG. Cockpit communications——

Secretary ROCHE. —is commercial, meets GATM standards.

Senator LAUTENBERG. I think that's a pretty significant area of disagreement. Second, a private sector market must exist for these assets. Now the suggestion was made that government purchases by Japan or by the United Kingdom construct a private sector market, is that your contention, Secretary?

Secretary ROCHE. Sir, I think I said there are other markets because it can also be used as a lifter. The underlying airplane, the 767–ER200 is the aircraft of choice for air freighters.

Senator LAUTENBERG. So someone would buy a 767 outfitted to act as a refueling tanker strictly for cargo purposes?

Secretary ROCHE. No, sir, the plane is also a cargo carrier and it's designed, our specifications also design it as a cargo carrier. You can fill the upper half with cargo and carry less fuel.

Senator LAUTENBERG. It just doesn't seem like it would be a very good private sector purchase given the cost of the airplanes. Third part, lease payments may not exceed 90 percent of the fair market value, this is obviously a technical issue, but it's one of the six-part test, and I guess the question is for the CBO, does it meet this part of the six-part test?

Mr. HOLTZ-EAKIN. In our view, no. The Air Force analysis indicates that by including the construction and financing it would be 89.9 percent. We don't think it's appropriate to include that financing, which puts it over 90 percent, that's subject uncertainty in the evolution of construction costs as well.

Senator LAUTENBERG. My time is all but up. The last part is that there can't be a bargain purchase price, and this is one where we'd probably say, well, we hope there's a bargain purchase price at the end but unfortunately if there is a bargain purchase price at the end it doesn't qualify. You wanted to address those?

Secretary ROCHE. Yes, sir, only that these same issues were addressed by the Office of the Secretary of Defense and certainly by the Office of Management and Budget, and when all was said and done, they approved going forward. The argument my colleagues have is my OMB.

Senator LAUTENBERG. I appreciate that distinction but we're beholden to a certain extent to comply with the rules and requirements and the scoring requirements particular with the CBO.

Secretary ROCHE. OMB looked at the scoring issue and believed that it would not be scored to begin with as a purchase.

Senator LAUTENBERG. Finally, given that the CBO argues that they have to score this as a lease purchase, if you could answer for me, Mr. Holtz-Eakin, what is the difference in budget authority? We heard a lot of talk about how the budget authority constraints would prevent us from doing an up-front purchase over the first four or six years. I look at this total and I see that the direct purchase would require $3.6 billion less in budget authority over the first four years than the lease, is that correct?

Mr. HOLTZ-EAKIN. That's correct.

Senator LAUTENBERG. Am I adding the right numbers?

Mr. HOLTZ-EAKIN. You are.

Senator LAUTENBERG. Secretary, any response?

Secretary ROCHE. I am not familiar with the details of their study. We would gladly take a look at it and give you a side-by-side comparison.

Senator LAUTENBERG. I would appreciate that. My sense is that that's what the CBO attempted to do here is a fair side-by-side comparison, apples to apples, 100 planes, same schedule, and at the end of the day I look at the budget authority and the outlays over the first three or four years, this critical period, and we'll all agree it's a critical period, and I see that it's actually less budget authority and less outlays if we purchase the tankers, and I would hope you would take a look at that.

I'm fairly new to this discussion and I'm sorry to bore everybody with the scoring but it gets us into trouble, but at the same time, this time it may actually lead us to make a good decision.

Secretary ROCHE. I would only point out that OMB and the others looked at all of this, and it's a set of assumptions and it's how you calculate and there are differences of opinion, and we've gone by the rules we were supposed to go by, which is through the Secretary of Defense, argue the case, then to the Office of Management and Budget, argue the case.

Senator LAUTENBERG. Thank you very much. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Brownback?

Senator BROWNBACK. Thank you, Mr. Chairman. Thank you, gentlemen. I want to ask Secretary Roche, has OMB had the chance to review the reviews and the comments by CBO, GAO, CRS, have they gone through?

Secretary ROCHE. I don't know, Senator. I don't know.

Senator BROWNBACK. You don't know whether they've had a chance to review any of these analyses?

Secretary ROCHE. Correct, sir. I do not know if they have.

Senator BROWNBACK. Okay. It seems to me that that would be an important thing to allow them or have them to do. I wonder, on the report put forward by CRS, one of the questions that I had that I don't think has been asked and it seems like it's been a pretty good questioning period, has been the lease price that Mr. Bolkcom was saying that we're paying much higher lease price than we should pay as a lease price. Do I understand your comment, Mr. Bolkcom, on that others are questioning whether we ought to lease and you're questioning whether we're getting a very good lease price, is that correct?

Mr. BOLKCOM. It is, sir. This is based on one formula that's used in the leasing business.

Senator BROWNBACK. Okay. That's the International Lease Finance Corporation, it's formula. Have you had a chance to look at that, Secretary Roche?

Secretary ROCHE. No, sir, I have not.

Senator BROWNBACK. Okay, because it seems like that's one to me I'd look at. I see your point and I was on and involved at this at an early stage as well and you have a lot of restrictions that you're having to operate under, we could look back now and say, well, let's change those restrictions so we change the environment, that's tough to do, number one, and so you've got to operate under those, but if we're not getting the best lease price, that would seem to be that's something that we ought to be looking at. Although having said that, this is one of the most reviewed financing arrangements purchases that I believe the U.S. military has ever done. Would you agree with that, Secretary Roche?

Secretary ROCHE. I would think so, yes, sir.

Senator BROWNBACK. Have you been involved in anything with any more review than this one has had?

Secretary ROCHE. No, Senator.

Senator BROWNBACK. Anywhere close to it?

Secretary ROCHE. No, Senator.

Senator BROWNBACK. And I think everybody would agree as well we do need to get the tankers. This is an aging fleet and it's going to continue to age and it's already having corrosion problems so it's something we need to move forward with. We all want to save whatever money we possibly can on this operation and I know you do as well. I would hope you could look at those leasing formulas by this one group, now I don't know if that's one that could be applicable here in this particular case or not. Thank you, Mr. Chairman.

The CHAIRMAN. Secretary Roche, are you familiar with a memorandum dated January 20 from a Mr. Ken Krieg, the Director of PANE, subject PANE analysis of KC–767 lease program?

Secretary ROCHE. Yes I am, Senator.

The CHAIRMAN. It says, our A–94 analysis indicates the provision lease costs more than the equivalent purchase of tanker aircraft measured, and then your dollars lease cost exceed by six being basically what these three are saying, our analysis shows the current draft lease fails to meet the requirement of OMB circular A–11. You're familiar with this?

Secretary ROCHE. Yes, sir.

The CHAIRMAN. What happened then?

Secretary ROCHE. I'll be glad to tell you, Senator. Ken Krieg gave that to me. We met within 24 hours. We said, all right, we have to go back and make sure that each of these things are addressed and over the course of time since then we did address them, with Ken Krieg and with the Under Secretary of Defense for Acquisition.

The CHAIRMAN. Well, I have also a e-mail here from Patty Armstead asking you to put pressure on Mike Wynn to convince PANE to write new letter essentially undoing the first letter. He said he was not going to answer, would get in trouble no matter how he answered. John Manning attempting to get meeting for you tomorrow. Rote said he was going to talk to Wolfowitz tomorrow.

Secretary ROCHE. No, sir, I talked to Ken Krieg and in fact I told him, don't bother writing another letter. We understood these were his arguments and we worked the arguments. I don't know who the other people are.

The CHAIRMAN. Well, it seems to me what they're saying here is still the case. The OMB circular requirements include a requirement the present value of the lease payments be less than 90 percent of the fair market value, that hasn't changed, no inherent economic efficiencies relative direct purchase of tankers, therefore more expensive in the long run, that hasn't changed. Everybody admits, even the Secretary of Defense admits that it's more expensive, measured then your dollars lease cost exceed purchase cost by $6.0 billion, all of these are still the case.

Secretary ROCHE. Mr. Chairman, those were positions put forward by PANE to the leasing panel chaired by the Under Secretary of Defense for Acquisition——

The CHAIRMAN. And it's still true.

Secretary ROCHE. —also the controller.

The CHAIRMAN. And it's still true.

Secretary ROCHE. They believe, the Under Secretary of Defense for Acquisition, we believe that those were all worked through. My colleagues don't agree.

The CHAIRMAN. How were they worked through? What has changed here?

Secretary ROCHE. The position of those individuals based on further discussion.

The CHAIRMAN. See, but the facts themselves haven't changed, but the position has changed.

Secretary ROCHE. Chairman, a lot of those facts are based on assumptions and modeling.

The CHAIRMAN. So are all facts. Well, Mr. Secretary, you didn't do an analysis of alternatives which is standard for acquisitions, even though as you mentioned there is exception, you didn't do a formal study of the corrosion problem, you overruled the Institute of Defense Analysis, which you asked to give the analysis, they haven't changed their position, and now you haven't even finished the negotiations. But you want the Senate Armed Services Committee tomorrow, the last Committee, to go ahead and approve without you having completed two, quote, very important aspects of it, the most favored customer, and the 15 percent return on sales provisions. Remarkable.

Mr. Holtz-Eakin, Mr. Curtin, and Mr. Bolkcom, do you think that Congress should approve of this deal without the resolution of those two issues? Mr. Holtz-Eakin?

Mr. HOLTZ-EAKIN. No, I do not.

The CHAIRMAN. Mr. Curtin?

Mr. CURTIN. Well, I think, Mr. Chairman, that you've got to consider the military need here along with the cost side. Clearly I concede that the cost is more expensive to lease, whether that's the way you want to go is your judgement based on whether——

The CHAIRMAN. My question was do you think that Congress, the final committee, they've already gotten the three, should approve before those two aspects of the deal are completed?

Mr. CURTIN. No, I think they should see how those come out because those are pretty important.

The CHAIRMAN. Mr. Bolkcom?

Mr. BOLKCOM. Senator, I don't have the flexibility, I'm afraid, of my colleagues. CRS can't really take a policy position, but I will just point out that on our report we find a number of questions that still need to be answered.

The CHAIRMAN. Thank you very much. Any further questions or comments? Senator Cantwell?

Senator CANTWELL. Are we having a second panel?

The CHAIRMAN. Yes.

Senator FITZGERALD. Just one final question. Mr. Secretary, I know this is under investigation, but I am concerned about reports that a deputy of yours who was involved somehow in analyzing this transaction left the Department of Defense, left the Air Force in November of last year and then wound up working for Boeing in January. How do you prevent employees from in essence being rewarded by helping a private contractor by being given a job at that company? Are there no regulations, no cooling-off period in place?

Secretary ROCHE. Senator, there are a lot of regulations, and to the best of my knowledge, Ms. Druyun followed those to the letter. One of them is that she not return to the Pentagon, not be involved in any negotiations or discussions. I've not seen her since she's retired, I don't know if anyone else has, but she has stayed far away, she's abided by those by the letter that the time she left, this was still a hotly debated subject in the Department of Defense, so she had not taken this to any sort of a conclusion, and the investigation as the Chairman points out is the use of numbers and if it's proprietary information of the other bidder then in fact using those numbers were wrong, if it's open source information, to be found out, but if it was proprietary it is wrong. But the rules for employment after working at the Department of Defense, especially for people in the acquisition world, are very strict and we make sure that they're adhered to, and if we find any violations we report it.

The CHAIRMAN. Not the first time recently that Boeing has been in possession of proprietary information. I thank the panel. I thank you very much for being here.

The next panel is Lieutenant General John B. Sams, Program Manager of the Tanker Program, Military Aerospace Support, The Boeing Company; Dr. J. Richard Nelson, Assistant Director, Institute for Defense Analyses, Cost Analysis and Research Division; Mr. Steven Ellis, Executive Director, Taxpayers for Common Sense; Mr. Eric Miller, Senior Investigator, Project on Government Oversight.

I'd like to welcome the witnesses, and Lieutenant General Sams, please proceed with your testimony and you might want to wait a minute until we quiet things down a little bit.

General SAMS. Yes, sir, Mr. Chairman.

The CHAIRMAN. Welcome to the witnesses. Mr. Sams, please proceed, General Sams.

STATEMENT OF LT. GEN. JOHN B. SAMS, JR. (USAF, RETIRED), PROGRAM MANAGER, USAF 767 TANKER PROGRAM, MILITARY AEROSPACE SUPPORT, THE BOEING COMPANY

General SAMS. Mr. Chairman and distinguished Members of the Committee, my name is John Sams and I am the U.S. Air Force KC–767 program manager for The Boeing Company. I'd like to thank you for providing this opportunity, sir, to provide this testimony today. I do not have a written statement to submit for the record, but instead I'm prepared to provide these very brief oral remarks.

Almost 24 months ago we began this journey. We knew that it would be breaking new ground pursuing a federal acquisition regulation, FAR Part 12 commercial acquisition for 100 new tankers. Commercial practices like leasing are both common and accepted practice in the commercial aircraft business and business in general, but not necessarily traditional in U.S. Government acquisition. Indeed, if successful with a commercial approach to this acquisition, we could put these assets in the hands of our Air Force crews a full 5 years before traditional government FAR Part 15 acquisition.

In the process we may perhaps jump start a recapitalization of the fleet of 544 KC–135s, a process that would take almost 30 years to complete if this or follow-on aircraft were procured at similar rates. Perhaps we could invigorate new ideas that could reduce the time it takes to field new systems for our military by streamlining processes and reducing risk to the government. We also recognize that this would be a thoroughly staffed and scrutinized program, as well it should. To be successful we had to accomplish three major goals ensure this was good for the war fighter, validate this was a good deal for the United States Government, and lastly ensure it was a good deal for the taxpayer.

We believe that we have achieved these goals. First, is this the right aircraft for the war fighter and the crews that will fly it? Key to successful war fighting is the ability to operate joint and coalition forces interchangeably and here the 767 excels. Able to refuel both boom and drogue-capable receivers on the same mission, the 767 will provide enhanced interoperability and flexibility to the battle space. With the ability to itself be air-refueled as we've discussed here today, it could remain on station as a tanker almost indefinitely.

While more than meeting the requirements of the Air Force, this aircraft can take off from an 8,000 foot runway, a standard across the world, and offload 40,000 pounds more fuel at 1,200 nautical miles radius of action than the aircraft it is replacing. It would take two KC–135s to offload as much fuel at that distance. On a cargo mission, the aircraft can deliver 10 palettes at a range of over 5,000 nautical miles. It would take three KC–135s to deliver this many palettes, and one palette would be left behind on the ramp.

If the mission is to carry military troops into forward locations like Mogadishu or Kandahar, places where commercial aircraft of the civil air reserve fleet should not go, the KC–767A can carry up to 190 troops. It would take three KC–135s to deliver this many troops and 19 would be left behind on the ramp. Yes, this aircraft is good for the war fighter.

Second, we must validate this as a good deal for the Air Force. When the negotiations began we heard estimates form various agencies that the lease alone would cost up to $31 billion. In fact, after 18 months of negotiations with the Air Force, the actual then-year cost is about half that estimate, or $16.6 billion. As indicated in the Air Force report to Congress, when the net present value of this is taken into account in Fiscal Year 2002 dollars, this value is actually $11.4 billion, and really the way that the Government needs to, or validates the true cost of items is comparing like dollars, and that's why the net present value assessments are so critical, and as we've discussed here, susceptible to the assumptions made.

But the Air Force only after Congressional authorization should certainly have the right to purchase the aircraft at the end of the lease. Therefore, we negotiated a purchase offer at the conclusion of the lease for the then-year price of $4.4 billion. Remember these aircraft will be coming off lease between the years 2012 and 2017, and so we're talking about dollars in the 2017 time frame. And when the purchase offer is applied to the same net present value assessment in Fiscal Year 2002 dollars, the value is actually $2.6 billion, and so the bottom line. In net present value FY 02 dollars, the total cost of the lease plus purchase at the end if approved by Congress is $14 billion.

And the net present value assessment does not consider the over $5 billion in cost avoidance that was mentioned by Senator Stevens, which hopefully we can discuss, which is over and above the cost to fly and maintain the aging KC–135Es, dollars not spent on program depo maintenance, not spent on engine strut replacement, and not spent on avionics upgrades required on the KC–135E. Yes, I believe this is a good deal for the Air Force and the U.S. Government.

Lastly but no less important than the first two goals, we must validate this as a good deal for the taxpayer. To address this issue, we had to take some extraordinary steps not common even in commercial FAR Part 12 acquisitions. First, we sought permission for the Air Force to discuss price with a commercial airline customer of their choosing. That's very uncommercial-like because normally all of these arrangements are protected by nondisclosure statements. We had to get permission from that airline.

The Air Force took advantage of this on three separate occasions, and Boeing was not privy to those conversations. Second, we validated the Air Force had not in the last 17 years sold this green commercial 767–200ER to any customer for less. We believed our commercial customers will understand that this is the right thing to do. Additionally, we provided most favored customer clauses to the Air Force contractually stating that we would not sell either the–200ER or the–200C, our new minor model for the tanker to anyone else in the future for less. If we do, Boeing will rebate the difference to the United States Government.

Finally, we contractually stated we would cap our earnings on the 767 green aircraft and separately cap our earnings on the tanker modification to a 15 percent return on sales. This is not guaranteed earnings. It's a ceiling consistent with DOD federal acquisition regulations, contract profit guidelines. Yes, we believe we have negotiated a proposal that is fair and equitable to the taxpayer.

Mr. Chairman and Members of the Committee, this is a very challenging, firm, fixed price program for the Boeing Company, with the risk of the development, the production, and the on-time delivery of the aircraft squarely on our shoulders, not on the Government's. Thank you very much for this opportunity to address the Committee, and I look forward to your questions, sir.

The CHAIRMAN. Thank you. Dr. Nelson.

STATEMENT OF DR. J. RICHARD NELSON, ASSISTANT DIRECTOR, COST ANALYSIS AND RESEARCH DIVISION (CARD), INSTITUTE FOR DEFENSE ANALYSES (IDA)

Dr. NELSON. Mr. Chairman and Members of the Committee.

The CHAIRMAN. You need to pull the microphone over, Doctor.

Dr. NELSON. Mr. Chairman and Member of the Committee, I am pleased to come before you today to talk about IDA's estimate of the purchase price of a KC–767A tanker combi aircraft. A written statement has been provided for the record. I will make some brief summary remarks. In January 2003, the Institute for Defense Analyses was tasked by the Office of the Undersecretary of Defense, Acquisition, Technology, and Logistics, and the Office of the Director, Program Analysis and Evaluation to estimate the unit purchase price of the KC–767A tanker combi aircraft. The term "tanker combi" indicates that the aircraft can serve as an air refueling tanker or carry freight or carry passengers or combine freight and passengers. This is the airplane that we addressed.

The objective of our task was to estimate the unit purchase price. With regard to other issues, this was the scope of our task specifically. We did not investigate the condition of the KC–135E or R fleet or the requirement for a tanker replacement. We were not asked to evaluate any other aspect of the proposed acquisition, and therefore did not address provisions of the lease, financing, suitability of lease, or any alternatives to the proposal.

To estimate the tanker combi unit purchase price, we separated our analysis into several segments. That included the following: the basic 767–200ER enhanced features coming from the Boeing 767 family selectively, some from the 300 and some from the 400; the combi modifications to allow for the freight or passenger or combination; the auxiliary fuel tanks that were being added to the airplane; and the tanker and other USAF unique modifications, including the boom, drogue, the RARO, those tanker mods plus also some avionics modifications such as Link 16. And then we also addressed development costs.

The proposed program would use FAR Part 12 guidelines written for the acquisition or lease of commercial items. The establishment of a reasonable price under these rules would normally rely largely on prices for the same or similar items in the commercial marketplace, and since the market for large tanker aircraft are limited, this information was not of value for rigorous determination of reasonable prices. Consequently, while our analysis made use of commercial pricing wherever possible, we relied on traditional cost analysis techniques, where estimation by commercial pricing was not practical.

Our analyses relied on data from a variety of public sources including other government sources, some of whom you've been hearing from today. The analyses of consultant organizations hired by IDA and familiar with the airline industry, internal IDA proprietary data and models, data supplied by Boeing, data provided by other aerospace suppliers, and data supplied by the Air Force. As a result, we feel that the evolution of our task through this January to May time period has resulted in a methodologically conservative approach that has produced a high quality unit price estimate.

Our estimate is summarized according to the segments above in our final report. We believe that the $120.7 million per unit is a reasonable unit purchase price estimate for the proposed 100 KC–676A aircraft. IDA and the OSD sponsors have provided a redacted version of our report and the privileged information version is available in the Pentagon.

Mr. Chairman and members of the Committee, thank you for your attention. I'm available for questions.

[The prepared statement of Dr. Nelson follows:]

PREPARED STATEMENT OF DR. J. RICHARD NELSON, ASSISTANT DIRECTOR, COST ANALYSIS AND RESEARCH DIVISION (CARD), INSTITUTE FOR DEFENSE ANALYSES (IDA)

Mr. Chairman and Members of the Committee, I am pleased to come before you today to talk about IDA's estimate of the purchase price of the KC–767A Tanker/Combi Aircraft.

Introduction

In January 2003, the Institute for Defense Analyses (IDA) was tasked by the Office of the Under Secretary of Defense Acquisition Technology and Logistics and the Office of the Director, Program Analysis and Evaluation to estimate the purchase price of the KC–767A Tanker/Combi aircraft. The Tanker/Combi designation indicates that the aircraft can serve as an air refueling tanker or carry freight or carry passengers or combine freight and passengers.

Description of Proposed Aircraft as Assessed by IDA

The KC–767A Tanker/Combi aircraft is to be based upon the commercial B767–200ER. Modifications would include the addition of features available on other Boeing 767 models, as well as changes required for the military application. In the tanker role, total fuel capacity is to be just over 200,000 pounds, including up to 41,000 pounds carried in added auxiliary fuel tanks. The KC–767A would have the capability to perform refueling by both the hose/drogue and boom methods (not simultaneously) from the aircraft centerline and would also be able to receive fuel from other tanker aircraft. The cabin of the KC–767A is to be convertible to three configurations. In the passenger configuration, the KC–767A would accommodate up to 190 passengers and 10 crewmembers. The freight configuration would allow carriage of up to 19 cargo pallets and 10 crewmembers. The combination (so-called "Combi") configuration is to have the capacity for simultaneous carriage up to 10 pallets, 10 crewmembers, and 70 passengers.

Objective and Scope of the Task

The objective of the IDA task was to estimate a unit purchase price for 100 KC–767A aircraft. We did not investigate the condition of the KC–135E/R fleet or the requirement for a tanker replacement. We were not asked to evaluate any other aspect of the proposed acquisition and therefore did not address provisions of the lease, financing, suitability of leasing, or any alternatives to this proposal. Consequently, the purchase price for the fleet of KC–767A aircraft is what I am prepared to discuss today.

Methodology and Data Sources

To estimate the KC–767A Tanker/Combi purchase price, we separated the acquisition into several segments:

- *Basic 767–200ER*—the commercial aircraft upon which the KC–767A design would be based.
- *Enhanced B767 Features*—the features from other B767 models that would be added to the basic B767–200ER design to build toward the KC–767A.
- *Combi Modifications*—the modifications to the B767–200ER that would allow the carriage of passengers, freight, or both simultaneously.
- *Auxiliary Fuel Tanks*—the lower fuselage fuel tanks, pumps, and installation materials required for additional fuel capacity in the KC–767A.
- *Tanker and Other USAF-Unique Modifications*—the changes required to give the KC–767A its refueling, fuel-receiving, and military-unique capabilities.
- *Development Costs*—the investment required to create and certify the KC–767A design.

The proposed KC–767A program would use FAR Part 12 guidelines written for the acquisition or lease of commercial items. Under these guidelines, the contractor is not required to provide cost estimates, or any other data not normally supplied to commercial customers. The establishment of a reasonable price under these rules would normally rely largely on prices for the same or similar items in the commercial marketplace. However, the KC–767A Tanker/Combi aircraft acquisition involves modifications that do not easily lend themselves to this approach, particularly in the area of military aerial refueling capability. The market for large tanker aircraft is limited and of little value for rigorous determination of reasonable prices. Consequently, while our analysis made use of commercial pricing wherever possible, we relied on traditional cost analysis techniques where estimation by commercial pricing was not practical.

Our analysis relied on data from a variety of public sources, including other government sources, the analyses of consultant organizations hired by IDA, internal IDA proprietary data and models, data supplied by Boeing, data provided by other Aerospace suppliers, and data supplied by the USAF.

Task Results

The analysis examined the proposed aircraft in detail, and incorporated information provided by Boeing during and after briefings at their facility in Wichita, Kansas. We feel that the evolution of our task through the January to May time period has resulted in a methodologically conservative approach that has produced a high quality unit price estimate. We also performed an internal rate of return (IRR) analysis on an estimate of Boeing's initial investment and found that our price estimate would provide Boeing with an attractive IRR for the time-period, and considering the risks involved. We believe that $120.7 million is a reasonable unit purchase price estimate for the proposed 100 KC–767A aircraft. Our estimate is summarized in the following table according to the segments identified in the methodology.

Summary of KC–767A Tanker/Combi Purchase Price Analysis

Taxonomy Element	IDA Unit Price Estimate (FY02 $M)	Primary Analysis Technique	Primary Data Sources
Basic B767–200ER	72.1	Commercial Pricing	Consultants, Department of Transportation data
Enhanced B767–200ER Features	1.6	Commercial Pricing	Consultants, Boeing, USAF data, IDA models, vendor quotes
Combi Modifications	9.5	Commercial Pricing	Consultants, public data
Auxiliary Fuel Tanks	6.3	Cost analysis	Vendor quotes, IDA models
Tanker and Other Modifications	20.3	Cost analysis	IDA models, USAF, Boeing
Development Costs	10.9	Cost analysis	USAF, IDA models
Total	*120.7*		

Mr. Chairman and Members of the Committee: Due to the proprietary information agreement that IDA has signed with The Boeing Company, I cannot divulge any proprietary data that we have obtained under this agreement. IDA and the OSD sponsors have provided a redacted version of our report, and the privileged information version can be read in the Pentagon.

Mr. Chairman and Members of the Committee: Thank you for your attention. I am available for comments/questions.

The CHAIRMAN. Thank you very much Dr. Nelson. Mr. Ellis.

STATEMENT OF STEVE ELLIS, VICE PRESIDENT OF PROGRAMS, TAXPAYERS FOR COMMON SENSE

Mr. ELLIS. Thank you. Good afternoon, Chairman McCain, Senator Brownback, Senator Cantwell, and thank you, Chairman McCain, for your strong leadership on this issue. I'm Steve Ellis, Vice President of Programs at Taxpayers for Common Sense, a national budget watchdog. My organization has closely analyzed the proposed lease of Boeing 767s to be converted into tanker aircraft since we first heard of it shortly after the tragic events of September 11, 2001. The heart of the discussion centers on three major questions: when do we need to replace the KC–135 fleet, with what, and what is the proper way to accomplish it.

But before beginning that discussion, I have to say that we were shocked by the recent revelations of the back room deals that got the lease deal inked. This confirms to many that the fix was in and that the Government cares more about a company with deep pockets than the average taxpayer. As you read the recent stories detailing the efforts to seal this $30 billion deal, it becomes increasingly hard to figure out where the blue Air Force uniform ends and the pinstripe of Boeing executives begins. In effect, Air Force officials became the silent business partners of Boeing.

Taxpayers for Common Sense understands that the Pentagon's Inspector General will be investigating the actions of a former Air Force official regarding this deal as has been previously discussed. We are strongly supportive of this initiative and hope it leads to a full investigation of the entire deal process. Because the deal is more than just Pentagon waste, the lease will have a significant negative impact on servicemen and women on the war fighter. The Air Force's procurement agreed to keep all of their acquisitions intact as part of the rationale for leasing, which comes out of the operations and maintenance coffers. How many billions of dollars in training and maintenance will we have to forgo to make these lease payments?

The cost accounting gimmicks the Air Force is employing to hide the real cost of the lease are a sad microcosm of the issues we are facing budget-wide. We are staring a $480 billion deficit squarely in the face. We have backloaded costs into out-budget years and will have to service an enormous debt in 2012 right when we are making the first decisions about buying the KC–767s.

Even if you don't believe the KC–135 fleet needs to be replaced immediately, the issue does have to be addressed. The first step in this process is to evaluate the Air Force's predicted aerial refueling need for the next 30 to 50 years. We are clearly in a different climate than 40 years ago when the KC–135s first came on line. Different aircraft, including smaller, significantly more fuel efficient, unmanned aerial vehicles, more accurate and capable weapons that can decrease the number of combat sorties required, even the availability of leasing tanker service from private contractors in certain situations. To identify the true refueling need, the Air Force is supposed to develop an operational requirements document. However, the Air Force was rebuked by a Pentagon panel for working the equation backwards and developing requirements that would directly point to the KC–767.

The next step is the analysis of alternatives. But after the opportunity to lease 767s as tankers presented itself, actually it was authorized by Congress, interest in analyzing alternatives waned. Now the Air Force doesn't plan to complete the AOA until after the lease, when only a relatively small final payment to purchase the KC–767s remains. I can't say what all the alternatives to meeting aerial refueling needs are and neither can anyone else in this room. We have been presented with an analysis of forgone conclusions, essentially launching the new recapitalization effort of our tanker fleet without any real objective analysis of our needs and options.

We do know a few of the aerial refueling alternatives, one short term option to re-engine some of the KC–135Es into Rs, or we could use DC–10s and convert them into more KC–10s, which are more capable than either the Rs or the proposed KC–767. Finally, there are the more discussed options of leasing KC–767s under the terms of the nearly finalized deal or buying them outright. Simply put, leasing to buy is always more expensive than an outright purchase. In certain settings, leasing makes sense, but it is an expensive, inefficient, and inappropriate route for major weapons procurement. According to an independent analysis, the taxpayer is paying a 19 to 27 percent premium to lease. Those additional dollars could buy as many as 35 more tankers.

In analyzing the cost of outright purchase, the Air Force created a straw man that ignored the potential of a multi-year purchase, overstated inflation costs and progress payments, used an improper, too-long discount rate, and devised a progress payment schedule that was inherently more expensive. Despite the Air Force's efforts to play down the savings, when you work the numbers, an outright purchase would be $5.7 billion to $6.9 billion less.

The chickens will come home to roost in 2012, when we enter the heart of the tanker recapitalization at the same time we are buying 100 joint strike fighters at a cost of $7 billion per year. These two acquisitions alone would gobble up 70 percent of the Air Force's aircraft procurement budget. In light of all the recent questions that have been raised, I urge you to ask your colleagues on the Senate Armed Services Committee not to approve this deal. The terms and conditions of the lease are still not finalized and you are being asked to vote on it. The war fighter and taxpayers are counting on you to stop this juggernaut until we get answers to critical questions about our tanker fleet. Thank you very much.

[The prepared statement of Mr. Ellis follows:]

PREPARED STATEMENT OF STEVE ELLIS, VICE PRESIDENT OF PROGRAMS, TAXPAYERS FOR COMMON SENSE

Good afternoon. I'm Steve Ellis, Vice President of Programs at Taxpayers for Common Sense, a national non-profit budget watchdog. My organization has closely analyzed the proposed lease of Boeing 767s to be converted into tanker aircraft since we first heard of it shortly after the tragic events of September 11, 2001.

Before entering the heart of the discussion: when do we need replace the KC–135 tanker fleet, with what, and the proper way to accomplish it, I have to state that even we were shocked and disturbed by the recent revelations of the backroom deals that got this lease deal inked.[1] This turn of events confirms many American's belief that the fix was in and the government cares more about a company with deep pockets than the average taxpayer. How deep? A Defense Week article published yesterday documented that Boeing executives contributed $22,000 to Senator Stevens 2002 re-election campaign at about the same time the Defense Appropriations bill—which gave birth to this lease deal—was being considered.[2]

Taxpayers for Common Sense has been disturbed by the U.S. Air Force's exceptionally close relationship with the Boeing Corporation throughout the negotiations on this lease. As you read the recent stories detailing the efforts to seal this $30 billion deal, it becomes increasingly hard to figure out where the blue Air Force uniform ends and the pin stripe of Boeing executives begins. In effect, the Air Force officials became the silent business partners of Boeing. Taxpayers for Common Sense wants the deal and the actions of Air Force and Boeing personnel fully investigated: the back scratching, the apparent sharing of proprietary information, the attacks on dedicated civil servants must be uncovered. These revelations are a clarion call for fundamental procurement reform.

Before you pass this off as just more Pentagon waste, remember the lease deal has a significant negative impact on servicemen and women—on the warfighter. The Air Force's procurement greed to keep all their other acquisitions intact is part of the rationale for leasing, instead of buying, the proposed KC–767. To protect other bloated acquisitions like the habitually over budget F/A–22 Raptor, the Air Force is raiding the Operations and Maintenance coffers. How many billion of dollars in training and maintenance will we have to forgo to make these lease payments?

The cost accounting gimmicks the Air Force is employing to hide the real costs of the lease are a sad microcosm of the issues we are facing budget wide. We are staring a $480 billion deficit in the face, the largest ever in relative terms and more than 4 percent of Gross Domestic Product, approaching the mid-1980s highs.[3] We have backloaded costs into out budget years and are potentially facing the prospect of servicing a $9.1 trillion debt in 2013, right when we are making the first decisions about buying the KC–767s coming off lease.[4]

In light of all the recent questions that have been raised, I urge you all to urge your colleagues on the Senate Armed Services Committee not to approve this deal. Chairman McCain, Senators Ensign and Nelson, you all serve on the Armed Services Committee. The terms and conditions of the lease are still not finalized, and you are being asked to vote on it. The warfighter is counting on you to stop the juggernaut pushing this deal until we get answers to critical questions about our tanker fleet.

The questions that should be answered are: What do we need, what options exist to fill that need, and what is the best, most cost-effective way to pursue that.

What Do We Need?

Taxpayers for Common Sense, along with others, believe the Air Force's earlier assessments which concluded that replacement of our KC–135 fleet[5] is not an emergency.[6] Instead, Department of Defense should develop exactly what our predicted in flight refueling needs will be in the next half century and how best to meet them.

The tragic events of September 11, 2001 were the driver for this lease deal. Whether you believe the deal is a bailout for Boeing or that the increased operations tempo of the war on terror, Afghanistan, and Iraq accelerated the deterioration of the KC–135s, the starting point for the deal remains the same.

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[1] Julian E. Barnes and Christopher H. Schmitt. "Boeing's Big Bailout—Courtesy of the Air Force." *U.S. News & World Report.* August 29, 2003.

[2] John M. Donnelly. "Boeing Payments to Senator Raise Questions." *Defense Week.* September 2, 2003.

[3] Online NewsHour. "Federal Deficit to Hit Record $480 Billion in 2004, CBO Predicts." August 26, 2003. Available at *http://www.pbs.org/newshour/updates/deficit__08-26-03.html.*

[4] According to independent Federal budget experts, using a realistic assessment of Federal government expenses, the national debt is projected to rise from $4.0 trillion today to $9.1 trillion by 2013. Richard Kogan. "Deficit Picture Even Grimmer Than New CBO Projections Suggest." Center on Budget and Policy Priorities. August 26, 2003.

[5] The Air Force's KC–135 fleet consists of 543 aircraft: 131 of the less capable (mostly due to engines) KC–135Es, that are used by the National Guard and Reserve and 412 KC–135Rs used by active duty Air Force and some National Guard and Reserve units. The KC–135 is similar to the commercial Boeing 707 airframe. The Air Force also operates 59 of the larger KC–10 tankers, based on the DC–10 airframe. General Accounting Office. "Military Aircraft: Consideration in Reviewing the Air Force Proposal to Lease Aerial Refueling Aircraft (GAO–03–1048T)." July 23, 2003.

[6] Christopher Bolkcom. "The Air Force KC–767 Lease Proposal: Key Issues for Congress." Congressional Research Service. August 29, 2003.

In February 2001, the Air Force conducted an extensive Economic Service Life Study (ECLS) of the KC–135s that found "the fleet structurally viable until 2040." Additionally, the study found that aircraft availability would increase in the short run and then steadily and slowly decline until 2040. Finally, the study predicted that real cost growth would be 1 percent per year.[7]

Subsequent to the decision to pursue a lease, the Air Force began to claim increased maintenance concerns, a reduced mission capability rate (MCR) and conducted a May 2003 business cost analysis, which found costs increasing at a higher rate.

Air Force maintenance concerns with the KC–135E have changed over time. First they were too old, but more recently officials have focused on the tanker fleet being unsafe because of corrosion. However, there is only anecdotal information and the full impact of corrosion cannot currently be quantified due to the limited amount of reliable data. Regardless, corrosion is a relatively predictable and manageable problem that affects "all military assets, including approximately 350,000 ground and tactical vehicles, 15,000 aircraft and helicopters, 1,000 strategic missiles, and 300 ships." DOD-wide, aging systems have maintenance and corrosion issues, but services like the Navy which solely operates in a highly corrosive salt water environment have implemented effective corrosion control technologies and we urge the Air Force to follow suit.[8] Additionally, the Air Force has improved depot maintenance for the KC–135s in recent years.[9]

The mission capability rate is easily skewed by the time period selected for review. But two recent events are telling. A January 2003 Air Force Study found the MCR for the KC–135E & R at 85 percent, the Air Force goal for tanker aircraft. More interestingly, the KC–135's had an 86 percent MCR during Operation Iraqi Freedom, a rate that exceeded virtually all of the Air Force's aircraft: fighters, bombers and KC–10 tankers.[10]

Even if you don't believe the KC–135 tanker fleet needs to be replaced immediately, the issue has to be addressed. The first step in this process is to evaluate the Air Force's predicted tanker or aerial refueling need for the next 30–50 years. We are clearly in a different climate than when the KC–135s first came on line: different aircraft, including smaller, significantly more fuel-efficient unmanned aerial vehicles (UAVs); much more accurate and capable weapons that can decrease the number of combat sorties required for mission success; even the availability of leasing tanker service from private contractors in some situations.[11]

To identify the true refueling need, the Air Force is supposed to develop an Operational Requirements Document (ORD). However, it appears the Air Force worked the equation backwards and developed requirements that would point to the KC–767. In fact, the Air Force was rebuked by a Pentagon panel stating the ORD "should not be written for a specific aircraft."[12]

The Air Force has been keen to point out how the KC–767 would outperform the KC–135. That comparison misses two key points. Possibly the most critical element of a tanker, refueling capacity, is virtually identical for the two aircraft. And more importantly, the comparison is a red herring, who cares if the KC–767 outshines the KC–135, does it meet our needs better than other alternatives?

What are the Options?

The Analysis of Alternatives is a critical decision-making tool for guiding any major systems procurement. In the 2001 Tanker Requirement Study for FY05, the Air Force wrote "The need to address KC–135 replacement mandates an air refueling analysis of alternatives."[13]

But after the opportunity to lease 767s as tankers presented itself—actually was authorized by Congress—interest in analyzing alternatives waned. Now the Air

[7] Christopher Bolkcom. "The Air Force KC–767 Lease Proposal: Key Issues for Congress." Congressional Research Service. August 29, 2003. p2.

[8] General Accounting Office. "Defense Management: Opportunities to Reduce Corrosion Costs and Increase Readiness, (GAO–03–753)." July 2003.

[9] Christopher Bolkcom. "The Air Force KC–767 Lease Proposal: Key Issues for Congress." Congressional Research Service. August 29, 2003.

[10] Christopher Bolkcom. "The Air Force KC–767 Lease Proposal: Key Issues for Congress." Congressional Research Service. August 29, 2003.

[11] The U.S. Navy has leased tanker services and the UK's Royal Air Force is considering it. Christopher Bolkcom. "The Air Force KC–767 Lease Proposal: Key Issues for Congress." Congressional Research Service. August 29, 2003. p28–29.

[12] Julian E. Barnes and Christopher H. Schmitt. "Boeing's Big Bailout—Courtesy of the Air Force." *U.S. News & World Report.* August 29, 2003.

[13] Rep. Roscoe Bartlett. Transcript of Projection Forces Subcommittee of the House Armed Services Committee Hearing on Air Force Air Fueling Tanker Replacement. Federal News Service transcript. June 24, 2003.

Force doesn't plan to complete the analysis until after the lease, when only a relatively small final payment to purchase the KC–767s remains, essentially launching the new recapitalization effort of our tanker fleet without any real, objective analysis of our needs or options.

In fact, the Air Force wasn't really sure why they wanted to quickly lease these planes. According to recent press reports of internal Boeing e-mails, Dr. Marvin Sambur, Assistant Secretary of the Air Force (Acquisition) " is desperately looking for the rationale why the USAF should pursue the 767 tanker NOW," and that "Sambur is looking for the compelling reason the administration should do this now rather than push off to a future administration."[14]

As Representative Roscoe Bartlett (R–MD), chair of the Projection Forces Subcommittee of the House Armed Services Committee pointed out at a recent hearing on replacing the KC–135s and the lease deal, ". . . here we are, about to commit $16 billion of our children's money—by the way, we don't have any money; we're borrowing it from our kids and our grandkids—so, we're about to commit $16 billion of their money, and we have not completed the . . . analysis of alternatives. Wouldn't you be a little more sanguine about spending your children and grandchildren's money if we had the advantage of these studies?"[15]

I can't say what all the alternatives to meeting our aerial refueling needs are . . . and neither can anyone else in this room. We have been presented with an analysis of forgone conclusions. Recent press reports have indicated that this deal won't stop at 100 aircraft, we're on the hook for at lease 200, maybe more.[16]

What is the Best, Most Cost-Effective Way?

We don't know all the possible aerial refueling alternatives, but we do know a few of them. One is to re-engine some or all of the KC–135Es into "R"s. The KC–135Rs, which are modified and re-engined, are more capable and should provide additional breathing room as we pursue a fleet replacement. Perhaps even more fruitful would be to obtain used DC–10s and convert them into KC–10s, which are more capable than either the KC–135R or the proposed KC–767. Finally, there are the more discussed options of leasing KC–767s under the terms of the nearly finalized deal, or buying them outright.

Simply put, leasing to buy is always more expensive than an outright purchase. In certain settings, leasing makes sense—but it is an expensive, inefficient, and inappropriate route for major weapons procurement. For instance, leasing a car makes sense if you regularly buy new cars every few years. It doesn't make sense if you keep your car for ten years. Leasing can also make sense if you want to keep more cash on hand for operating needs, but you pay a premium for that. The proposed lease doesn't fit in either of these categories. The Air Force is going to buy and keep the tanker for decades, and the lease is not to keep more cash on hand for operations, it is to extend the Air Force acquisition dollars further, to buy more, with a balloon payment at the end.

The Congressional Budget Office, Office and Management and Budget, and General Accounting Office have all raised significant concerns about the lease. According to their analysis, the Air Force has broken current Federal budgetary and lease rules, the lease terms are fiscal irresponsible and this deal sets a terrible financial precedent for new weapons system procurement. According to the Congressional Research Service, the taxpayer is paying a 19 percent-27 percent premium to lease; those additional dollars could buy as many as 35 more tankers.[17] Industry experts also agree. "It's certainly not the most cost-effective way to do it," concluded Michael Allen who is the Chief Operating Officer of Back Aviation Solutions, a consulting firm.[18]

Some of these machinations can be explained by the Air Force's efforts to have the deal count as an operating lease, not a capital lease. One of the main interests of the Air Force is to hide the overall acquisition costs so as to avoid tightening scrutiny over procurement. Under an operating lease, obligations and outlays are recorded on a year-by-year basis instead of when the borrowing, purchase and interest

[14] Renae Merle. "Documents Detail Maneuvers for Boeing Lease." *The Washington Post.* August 31, 2003.

[15] Transcript of Projection Forces Subcommittee of the House Armed Services Committee Hearing on Air Force Air Fueling Tanker Replacement. Federal News Service transcript. June 24, 2003.

[16] Julian E. Barnes and Christopher H. Schmitt. "Boeing's Big Bailout—Courtesy of the Air Force." *U.S. News & World Report.* August 29, 2003.

[17] Christopher Bolkcom. "The Air Force KC–767 Lease Proposal: Key Issues for Congress." Congressional Research Service. August 29, 2003. p 67.

[18] David Bowermaster and Katherine Pfleger. "Is leasing Boeing jet tankers best deal for U.S. Taxpayers." Seattle Times. May 15, 2002.

payments are actually made. According to the Congressional Budget Office, the deal fails four of the six tests for an operating lease, and only meets the letter, not the spirit, of the fifth.[19]

To be treated as an operating lease, the asset:

- Must be general purpose, not built to unique government specifications—although it is based on a commercial airframe, a tanker is not general purpose.
- There must be a private-sector market for the asset—there have been a few purchasers of KC–767 aircraft, but the sales have only totaled 8 aircraft, and a market for 100 simply doesn't exist.
- The present value of the lease payments cannot exceed 90 percent of the asset's fair market value at the start of the lease—the lease payments total 93 percent of the outright purchase cost as determined by Boeing.[20]
- The lease cannot contain a bargain-price purchase option—the aircraft will have 80 percent of it's useful service life remaining after the six year lease, but will cost only 28 percent of the purchase price of a new KC–767.
- Ownership of the asset must remain with the lessor—technically, the aircraft are under control of the special purpose entity (SPE) created to facilitate this deal, however the government maintains significant control over the entity.
- The lease term cannot exceed 75 percent of the asset's useful life—the lease would meet this criteria, using only approximately 20 percent of the aircraft service life.

Boeing and the Air Force have consistently downplayed and lowballed the cost of the K–767 program to taxpayers. At the May 2003 press conference announcing the tanker deal, then-Under Secretary of Defense for Acquisition Pete Aldridge answered "yes" when asked if $5.7 billion in training and maintenance costs were included in the $16 billion lease figure. In fact, the opposite is true.[21]

In analyzing the cost of outright purchase, the Air Force created a "straw man" plan that ignored the potential of a multi-year purchase, overstated inflation costs in progress payments, used an improper—too long—discount rate, and devised a progress payment schedule that was inherently more expensive.[22] The Air Force's "straw man" plan resulted in purchase cost-savings of only $150 million. This lowball figure was prominently described in the body of the document, the fact that a multi-year procurement would yield a $1.9 billion savings over leasing was buried in a footnote.[23]

The Air Force still maintains that purchasing would only represent a $150 million savings over leasing, but independent studies found the actual savings would be between approximately $1.3 billion and $2.5 billion.[24] Adding those savings to the cost of purchasing the aircraft at the end of the lease and you arrive at between $5.7 billion and $6.9 billion saved by an outright purchase of the KC–767 over a lease to buy.

For instance, according to the Congressional Research Service, "Instead of negotiating the lease price to reflect the usage—either the length of time or the amount of hours flown—the Air Force negotiated the price to minimize the financing costs

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[19] Douglas Holtz-Eakin. "Assessment of the Air Force's Plan to Acquire 100 Boeing Tanker Aircraft." Congressional Budget Office. August 2003. p8–11.

[20] Air Force documents maintain that only 89.9 percent of the cost will be paid during the lease, but that figure includes the lease financing costs in the total, which of course would not be incurred in an actual purchase. Douglas Holtz-Eakin. "Assessment of the Air Force's Plan to Acquire 100 Boeing Tanker Aircraft." Congressional Budget Office. August 2003. p10.

[21] Edward "Pete" Aldridge, Undersecretary of Defense for Acquisition, Technology and Logistics. Transcript of Department of Defense Briefing on Results of the Tanker Lease Agreement. May 23, 2003. Federal News Service Transcript.

[22] Douglas Holtz-Eakin. "Assessment of the Air Force's Plan to Acquire 100 Boeing Tanker Aircraft." Congressional Budget Office. August 2003. p12–15. Christopher Bolkcom. "The Air Force KC–767 Lease Proposal: Key Issues for Congress." Congressional Research Service. August 29, 2003. p46–47

[23] Dr. James Roche, Secretary of the Air Force. "Report to Congressional Defense Committees on KC–767A Air Refueling Aircraft Multi-Year Lease Pilot Program." July 10, 2003. p. 4.

[24] The CBO estimated the purchase savings to be $1.3 billion—$2 billion. Douglas Holtz-Eakin. "Assessment of the Air Force's Plan to Acquire 100 Boeing Tanker Aircraft." Congressional Budget Office. August 2003. The CRS noted several of the same factors and estimated that savings of lease could be between $1.9 and $2.5 billion. Christopher Bolkcom. "The Air Force KC–767 Lease Proposal: Key Issues for Congress." Congressional Research Service. August 29, 2003.

and to make it easier for the Air Force to find resources to buy the Aircraft at the end of the lease." [25]

Contrary to the protestations of some lawmakers, it is unlikely that Boeing will shut down the 767 production line in the next couple years. There are enough 767s on order to last until 2006, including seven for Japan Air Lines, an order announced over the weekend.[26]

However, it is clear that the 767 line is nearing the end of its commercial life, especially with Boeing's new 7E7 coming on line. Being at the end of the line entails risks and rewards. The dwindling commercial sales for the 767 virtually ensures that DOD will be supporting a unique or orphan airframe in the later years of service life. It also means that because the market is sluggish, DOD should be getting greater price breaks. John Plueger, President and CEO of the International Lease Finance Corporation said that the U.S.—as possibly the most credit worthy purchaser—would "certainly command the highest concession levels offered by any aircraft manufacturer for commercial/civilian airliners." [27]

However, in spite of the drop in 767 sales, and Uncle Sam's credit record, Boeing hasn't offered its best price. According to reports, the fair market value as determined by the Institute for Defense Analysis is around $120 million—about $11 million less than what taxpayers are being charged for these tankers. Even so, news reports state the only way we even got into the ball park of the IDA number was to promise Boeing that the first hundred planes would be followed by hundreds more.[28]

While the Air Force and Boeing say the deal has been tailored to save money, the current unresolved lease terms make it impossible to determine how much the U.S. government, "the new deep pockets" customer will pay in the future. In fact, according to the U.S. News and World Report, Boeing documents point out that with a little political pressure, the lease deal could be worth more than $35-$40 billion to the company.[29]

A Political Decision

This is really an economic bailout masquerading as a national need. In an October 2001 letter to President Bush, Rep. Norm Dicks (D–WA) was clear about the ulterior motive behind this deal—propping up Boeing. After discussing job losses and cancelled aircraft orders, Rep. Dicks stated "that the Administration's economic stimulus package should include at least $2.5 billion for the purchase or lease of [767s] . . ." [30] Since then, the lease has been justified by the issue du jour. Jobs. KC–135 Corrosion. Increased Operations Tempo. A sweetheart deal.

Even Boeing's loss of the Joint Strike Fighter contract to Lockheed-Martin has become a rationale for this deal. A spokesman for Rep Jerry Lewis, the powerful Chairman of the House Subcommittee on Defense Appropriations said, "There is the concern that because of the Joint Strike Fighter contract, something has to be done to make sure we support all of our industrial base." [31]

The consideration of the JSF contract brings up an interesting point. The tanker lease is structured to postpone a major acquisition decision to avoid making decisions today. But procrastination won't help. At the end of the lease, we will be forced to buy more 767s to both continue KC–135 replacement and keep the Boeing production line going. Even lease proponents like Dr. Loren Thompson of the Lexington Institute freely admit that ". . . by the time this is all over, Boeing will sell the Air Force 600 767s for various large-body missions." [32]

But, just as we enter the heart of tanker recapitalization in 2012, we also will be in the middle of the JSF acquisition, buying 110 fighters at a cost of $7 billion

[25] Christopher Bolkcom. "The Air Force KC–767 Lease Proposal: Key Issues for Congress." Congressional Research Service. August 29, 2003. p66.

[26] Associated Press. "JAL orders 7 more Boeing 767s." September 1, 2003.

[27] ILFC leases more than 600 jet aircraft to 160 airlines worldwide, including 60 767s. Statement of John Plueger to House Armed Services Committee. July 23, 2003.

[28] 1 Julian E. Barnes and Christopher H. Schmitt. "Boeing's Big Bailout—Courtesy of the Air Force." *U.S. News & World Report.* August 29, 2003.

[29] Julian E. Barnes and Christopher H. Schmitt. "Boeing's Big Bailout—Courtesy of the Air Force." *U.S. News & World Report.* August 29, 2003.

[30] Rep. Norm Dicks. Letter to the President. October 4, 2001.

[31] James Dao and Laura M. Holson. "Boeing's War Footing; Lobbyists Are Its Army, Washington Its Battle Field." *New York Times.* December 12, 2001.

[32] Vernon Loeb. "Air Force Picks Boeing Over Airbus." *The Washington Post.* March 30, 2002. at D 13.

per year. Coupled with the tanker acquisition, 70 percent of the Air Force aircraft procurement budget would be spoken for.[33]

There are a lot of questions about whether this is a good deal or the right aircraft. If members of Congress determine that we need to help out—bail out—Boeing, then we should debate that. Not raid our operations and maintenance account.

Again, Taxpayers for Common Sense strongly urges you to oppose this lease. Thank you for inviting me here today. I would be happy to answer any questions you might have at this time.

The CHAIRMAN. Thank you very much, Mr. Ellis. Mr. Miller, welcome.

STATEMENT OF ERIC MILLER, SENIOR DEFENSE INVESTIGATOR, PROJECT ON GOVERNMENT OVERSIGHT

Mr. MILLER. Good afternoon. Thank you, Mr. Chairman and Members of the Committee, for asking me to testify today on an Air Force proposal to lease 100 tanker aircraft. I work as a defense investigator for the Project on Government Oversight, or POGO for short. POGO was established in 1981 and is a politically independent, nonprofit watchdog that strives to promote a government that is accountable to the citizenry. Because we investigate government fraud, waste, and abuse, this tanker proposal is right up our alley. For more than a year, POGO has conducted an ongoing, in-depth study of the tanker lease deal. In May 2002, we issued a critical report on the lease idea and since then we have been following this issue almost on a daily basis.

You already know that virtually every government oversight agency that has put a pencil to this proposal has concluded it costs more, billions more, to lease rather than purchase these commercial derivative tankers. You also hopefully realize that the essence of this proposal is to reward Boeing Company a hefty contract with little or no consideration for the taxpayers. Clearly tanker aircraft play a vital role in the mission of the U.S. military, but we believe the Air Force has failed to provide evidence that the current KC–135 fleet is in urgent need of replacement. POGO hopes to advance the debate on this very important issue because frankly we're very concerned that this is a bad deal for both the Pentagon and the taxpayers.

We believe this for a number of reasons. There is mounting evidence, much of it uncovered by your Committee's thorough research, that something about this lease isn't on the up and up. Frankly, we haven't seen a compelling case made yet that there is a critical need for these tankers, and even if there was, we'd be suspicious because the genesis of this agreement seems to be political. Contributing to our concern is the recent public release of an array of e-mails and other communications between Boeing and Air Force officials that suggest a coziness that is both unsettling and unhealthy. These e-mails give the appearance of an attitude that it's Boeing and the Air Force against the rest of the world and not one of a contractor/client relationship.

There's another problem. The Federal Government should not reward contractors with such extraordinary handouts if they do not have a record of integrity in business ethics. Three Boeing aero-

[33] Douglas Holtz-Eakin. "Assessment of the Air Force's Plan to Acquire 100 Boeing Tanker Aircraft." Congressional Budget Office. August 2003. p. 17.

space subsidiaries recently were suspended after an Air Force investigation revealed that Boeing was in possession of thousands of pages of Lockheed Martin proprietary documents. Unfortunately, this latest misstep by Boeing is only one of many. A year-long POGO study of the top 40 federal contractors documented 50 instances of what we have labeled misconduct or alleged misconduct by Boeing since 1990, establishing Boeing as the federal contractor with the third highest number of such instances.

Indeed, Boeing's investigation shows that as POGO's investigation shows that as recently as March 2003, Boeing and one of its subsidiaries agreed to pay an $18 million civil settlement with the government after being accused of 123 charges of arms control and international traffic and arms regulations. Rather than sweetheart deals, the Pentagon should be looking at suspending repeat corporate offenders from future contracts and from extending existing contracts while still under suspension.

Your Committee, Senator McCain, should be commended for taking on this controversial issue that has been fast working its way through other Committees with minimal examination. POGO hopes you will do all you can to stop it from becoming yet another in a series of Pentagon blunders. Thank you for inviting me to testify. I'm happy to answer any questions you have.

[The prepared statement of Mr. Miller follows:]

PREPARED STATEMENT OF ERIC MILLER, SENIOR DEFENSE INVESTIGATOR, PROJECT ON GOVERNMENT OVERSIGHT

I want to thank you for asking me to testify today on an Air Force proposal to lease 100 wide-body Boeing tanker aircraft—a proposal we believe is ill-advised for both the Pentagon and the taxpayers. The Project On Government Oversight (POGO) investigates, exposes, and seeks to remedy systemic abuses of power, mismanagement, and subservience by the Federal government to powerful special interests. Founded in 1981, POGO is a politically-independent, nonprofit watchdog that strives to promote a government that is accountable to the citizenry.

For more than a year, POGO has conducted an ongoing in-depth study into the tanker lease proposal. In May 2002, we issued a critical report on the tanker lease idea, "Fill 'Er Up: Back-Door Deal for Boeing Will Leave the Taxpayer on Empty." Only last week, we sent a letter to the Chairman and Ranking Member of the Senate Armed Services Committee urging the Committee to reject the proposal. Also, we have formally joined with such other public watchdog groups including Americans for Tax Reform, Taxpayers for Common Sense, and Common Cause in calling for an end to the deal. We hope the members of this committee will join in our fight to put an end to the unneeded and overpriced tanker lease.

Since we issued our report last year, the Air Force and some Members of Congress have continued a full-court press to secure funding for the tanker lease. It has become increasing clear that the costly lease proposal has little to do with helping the Nation's fighting men and women, and everything to do with padding the bottom line of an already prosperous defense contractor.

The lease idea that clearly began as a gift to Boeing has suspiciously morphed into a manufactured tanker shortage crisis. The deal was originally pitched by a few Members of Congress as a financial aid package of sorts for Boeing, a contractor that was ranked 15th in sales and 38th in profits on the 2003 Forbes magazine list. The company's rankings in sales and profits actually rose after 9/11.

One of those Members of Congress doing the pitching for Boeing was Representative Norm Dicks, Democrat of Washington, who wrote a letter to President Bush on October 4, 2001, using the tragic events of 9/11 as an excuse for promoting this bad deal.

"While we have promptly approved legislation that provides direct assistance to U.S. airlines, providing critical financial stability at this time, we have thus far not addressed the downstream impacts of this crisis, including the loss of work at Boeing," Dicks wrote. The tragic events of 9/11 should not be used as an excuse to discard common sense.

Then after it became clear that the lease was more expensive than an outright buy, Pentagon spin doctors began telling Congress a different story—the converted B–767 aircraft were urgently needed to replace an aging fleet of KC–135 tankers, a claim that has not been well supported.

Meanwhile, evidence against the lease idea has been mounting. In a report issued last week the Congressional Budget Office (CBO) became the latest government financial agency to join the chorus of critical voices. In fact, the CBO concluded in a damaging assessment that the proposed lease "would essentially be a purchase of the tankers by the Federal government, but at a cost greater than would be incurred under the normal appropriation and procurement process." The CBO also said the proposed lease does not meet the conditions for an operating lease as required by Office of Management and Budget rules.

Others, including the General Accounting Office, Office of Management and Budget, Congressional Research Service, and DOD contractor the Institute for Defense Analysis, all have suggested that leasing the tanker aircraft would be far more costly than purchasing them.

There is another problem. The Federal government should not reward contractors with such extraordinary handouts who do not have a record of "integrity and business ethics." Three Boeing space subsidiaries recently were suspended after an Air Force investigation revealed that Boeing was in possession of thousands of pages of Lockheed Martin's proprietary documents.

A POGO study documented 50 instances of misconduct or alleged misconduct by Boeing since 1990. Indeed, POGO's investigation shows that as recently as March 2003 Boeing agreed to an $18 million settlement with the government for alleged violation of the arms control act and international traffic in arms regulations.

Rather than sweetheart deals, we should be looking at suspending repeat corporate offenders from future contracts.

In response to criticism of the deal, Air Force officials, attempting to capitalize on Congressional support for new procurement funding, have only muddied the waters with distorted facts and contradictory financial projections. Yet, they too have also admitted that the lease would cost more than a purchase of the tankers.

Moreover, copies of e-mail communications between Boeing and Air Force officials made public by the Senate Commerce Committee last week point to an improper—if not outright illegal—cozy relationship between the defense contractor and the Pentagon. The e-mails suggest that the Air Force went to Boeing for ideas on how to sell the tanker lease rather than letting the facts speak for themselves. In a September 18, 2002 e-mail between two Boeing executives one told the other that the Air Force was "desperately looking for the rationale for why the USAF should pursue the 767 Tanker NOW."

Another e-mail even suggested that the Air Force's former acquisition chief, Darleen Druyun, shared Airbus prices with Boeing officials before she left to go work for Boeing. This unnatural closeness between contractor and the Air Force should be further investigated before the government enters into any formal lease or purchase agreement for new tankers.

Clearly, tanker aircraft play a vital role in the mission of the U.S. military, but the Air Force has failed to provide evidence that the KC–135 fleet is in urgent need of replacement. To the contrary, a May 2002 General Accounting Office preliminary study suggested the opposite, that the current fleet can be re-engined and updated to serve the military's mission until 2040. Air Force officials seemed to support the idea of keeping and renovating the current KC–135 fleet until the lease proposal was dangled in their faces by some Members of Congress eager to curry political contributions from a powerful defense contractor.

One of the arguments the Air Force makes is that the tankers can somehow be manufactured in a shorter period of time if they are leased. In reality, a leased aircraft is not built any faster. If the need is as critical as the Air Force suggests, then the new tankers should be budgeted for purchase like any other procurement item.

The Air Force's expressed concern over tanker shortages is not credible in light of its decision to decline the purchase of 36 new 767 tankers two years ago at a considerably cheaper price.

Simply put, Air Force leaders never said they even needed the tankers until they woke up one morning and saw a pile of money on the table. All of a sudden, they say the KC–135 tanker fleet is plagued with corrosion problems, and have even suggested that the current fleet of tankers is unsafe—even though the KC–135 mishap rate is lower than many other Air Force aircraft.

For several reasons, POGO strongly opposes the lease idea. The CBO analysis claims that over the period of the lease the taxpayers will spend $5.7 billion more to lease the aircraft over the cost of an outright purchase. In all, the CBO estimates the tankers will cost $161 million each if the Air Force exercises an option to purchase the aircraft at the end of the six-year lease period. An independent analysis by DOD contractor the Institute for Defense Analysis concluded that the aircraft should cost considerably less and still provide Boeing with a handsome profit.

Although the Air Force has just recently complained that its fleet of airborne gas stations is aging, its top brass never requested funding from Congress until recently. The purchase of the 100 tanker aircraft was not even on the Air Forces's list of top 60 budget priorities last year. The Air Force budget wish list included requests for such areas as bomber and fighter upgrades, aerial drone targets, family housing investment, a new C–130J, and readiness spare parts.

The Air Force most recently has claimed that the current tanker fleet is unsafe because of corrosion but offers no specific assessment of the extent of the problem. No wonder: A July 2003 GAO study concluded that there is no way to assess the extent of the corrosion problem because neither the DOD or military services have reliable data.

Until recently, the Department of Defense has projected that the tanker fleet could be flown for decades. In fact, General Richard Myers, Chairman of the Joint Chiefs of Staff, has said that the KC–135 tanker fleet is "relatively healthy" with "lots of flying hours left on them." The Air Force has not publicly disclosed any studies that contradict Myers statements, and the recent GAO study supported his observations with data supplied by the Air Force.

"As you know they've been re-engined," Myers said. "We're putting new avionics in the cockpit. There's been a lot of work done on those particular aircraft to keep them modern."

Myers' comments are consistent with the DOD's official position prior to learning of the lease proposal. In response to GAO criticisms, the DOD told the GAO that its tanker fleet would not need replacing for decades. "While the KC–135 is an average of 35 years old, its airframe hours and cycles are relatively low," DOD responded to the 1996 GAO tanker requirements study. "With proper maintenance and upgrades, we believe the aircraft may be sustainable for another 35 years."

By latest count, there are 545 KC–135 tankers in the Air Force fleet. Of that total, 134 are older E models and 411 are upgraded R models. The Air Force says it wants to use the 100 leased Boeing tankers to replace 127 of the 134 older E models beginning in 2006. The E models are the oldest and least capable tankers. For that reason, all of the E models currently are assigned to reserve and National Guard air units, while the newer R models are all part of the active Air Force fleet.

While the average age of the KC–135s is high, the actual hours of aircraft use are relatively low, according to the GAO. The Air Force itself projects that the E models have a lifetime of 36,000 flying hours and the R models can fly for 39,000 hours.

As of 1995, the GAO says the majority of the KC–135 fleet had logged a total of between 12,000 and 14,000 flight hours. From 1995 to late 2001, the average tanker has averaged about 300 hours a year, bringing the total average hours flown by most of the tankers to roughly 14,000–16,000, or less than half the total expected life of the aircraft. (The average could now be slightly higher because tanker hours have increased slightly since the war in Afghanistan.) By these calculations, not one of the E models, the oldest in the fleet, would reach its limit until 2040, according to the GAO.

Even if the Air Force's recently-crafted claims that there is an urgent need to replace KC–135 E models were true, the GAO says the quickest—and cheapest—solution may be to replace the engines of the older tankers and upgrade to R models at a cost of $29 million each. That means the bill to upgrade all 127 E models otherwise being replaced would only total about $3.6 billion, a mere fraction of the CBO's $21.5 billion estimate to lease 100 new Boeing 767 aircraft.

Even before the release last week of the communications between Boeing and Air Force officials, the tanker lease deal has been a textbook case of bad procurement policy and favoritism to a single defense contractor. The legislative add-on permitting the lease does not even attempt to cover up the acrid smell of back room dealing. It brashly subverts the competitive bidding process by authorizing the Air Force to procure 100 new tankers only if it leases them specifically from Boeing. Boeing could not have structured a better deal had it drawn the lease proposal itself.

This appearance of favoritism was the subject of inquiry at a February 12, 2002, Senate Armed Service Committee hearing on the proposed Fiscal Year 2003 defense budget. When questioned about the deal, Air Force Secretary James Roche admitted that Air Force officials did not even discuss it with Secretary of Defense Donald Rumsfeld, Armed Services Democratic Committee Chairman Senator Carl Levin, or ranking Committee Republican Senator John Warner. Such communication is customary in the case of large defense appropriations.

During the hearing, Roche was asked by Republican Senator John McCain if there had been discussions with Airbus, a division of European Aeronautic Defence and Space Company (EADS), a Boeing competitor also interested in selling wide-body tankers to the Air Force.

"Yes, sir. Back as far as October I made the point that if Airbus could come in and do something, we would be delighted to have that happen," Roche responded. ". . . I have met with [EADS Chief Executive Officer] Philippe Camus and have opened up the door for him if he wished to do something."

"But doesn't the legislation say the loan can only be Boeing 767's?" McCain fired back. "Yes, sir. But if Airbus did something that was particularly good, I would come back to the Congress, sir," Roche said.

Roche never did get back with Congress on the issue, but apparently was stung by hints of favoritism during the hearing. Only a week later, on February 20, 2002, the Air Force issued a formal Request For Information that gave interested tanker defense contractors only two weeks to submit a complex proposal for the lease of 100 refueling aircraft. Predictably, a cheaper-priced formal proposal by Airbus was rejected, and the Air Force is currently finalizing lease negotiations with Boeing.

While the leasing of major weapons systems, aircraft, and ships are rare, the Boeing 767 lease proposal is not totally without precedent. It bears a striking resemblance to a handful of long-term lease deals by the Navy to quickly put several dozen tanker ships into commission during the 1970s and 1980s. Although at the time the leases were purported to be cheaper than buying the refueling ships outright, the GAO has since concluded the leases actually resulted in a higher cost to the taxpayers.

Since the Navy leases, Congress has increased transparency of long-term leases and tightened the process to evaluate long-term leases of military equipment and weapons. Through a detailed process called "budget scoring," the military services are now required to assess the cumulative impact of a long-term lease and compare it to the cost of purchasing equipment before Congress agrees to appropriate the funding.

Now, there is a great danger that the Boeing tanker lease may be a sign of things to come and future leases could become more commonplace. In fact, the idea of leasing major weapons systems in the future has been a goal of the Pentagon since late 2001. In the name of flexibility the DOD has, in effect, declared war on close financial oversight of multi-year leasing of weapons systems, aircraft, and ships.

In a 2001 memo, Pentagon Acquisitions Chief E.C. Aldridge, Jr., and DOD Comptroller Dov S. Zakheim announced a new multi-year leasing initiative, instructing key Pentagon officials to help "identify candidate programs for acquisition by means of multi-year leases." Their memo said that long-term leasing of weapons systems has historically been rare because of statutory and regulatory "impediments."

POGO opposes such leases as a means for acquiring major weapons systems. They are likely to obligate the government to future debt that is not properly budgeted, costs more, and provides much less financial oversight.

Thank you for inviting me to testify before the Committee. I am happy to answer any questions.

The CHAIRMAN. Thank you very much, Mr. Miller. Dr. Nelson, help me out here. IDA was asked by the Air Force to do a study.

Dr. NELSON. No, sir. IDA was asked by the Under Secretary of Defense, Acquisition, Technology, Logistics——

The CHAIRMAN. To do a study.

Dr. NELSON. —and the Director of PANE to do a task.

The CHAIRMAN. And you completed that task in how long?

Dr. NELSON. We essentially began very late in January. We finished our work pretty much by end of April, mid–May, and then we documented our results, it went to the middle of July, so about 6 months.

The CHAIRMAN. So your product said that the cost per tanker should be $120 million each, is that correct?

Dr. NELSON. That was our finding, yes, sir.

The CHAIRMAN. Your finding? And yet the Air Force is about to enter into a deal for $131 million each, correct?

Dr. NELSON. Yes, sir.

The CHAIRMAN. Was there then conversations or discussions between you and the Secretary of the Air Force or PANE or the Under Secretary of Defense about the disparity, and it's a significant one, about what you thought what IDA analysis was of what should be the cost of the aircraft and what the deal that the Air Force is about to enter into?

Dr. NELSON. Well, Senator, cost analysts can differ.

The CHAIRMAN. Yes.

Dr. NELSON. Data can be different, methods can be different, application of analogies, scaling, there are a number of ways that things can be different. We met periodically with our sponsors and the Air Force and exchanged information, discussion about how we went about certain elements of our analysis.

The CHAIRMAN. Well, did they convince you that anything you had done was incorrect?

Dr. NELSON. No, sir.

The CHAIRMAN. So you still stand by your conclusions?

Dr. NELSON. Yes, sir.

The CHAIRMAN. Thank you. General Sams, I understand there are two outstanding differences as you heard earlier. Is there a prospect of resolving those two issues and completing and finalizing the leasing agreement?

General SAMS. Yes, sir, Mr Chairman. As I was briefed just before I came over here today by our folks who had been working with Air Force officials that we believe we have a path forward on those two issues.

The CHAIRMAN. Thank you. Senator Cantwell? And I thank the witness.

Senator CANTWELL. Thank you Mr. Chairman. Mr. Ellis, you mentioned in your closing comments, I don't think it's in your written statement, but you mentioned that you urged members of the Armed Services Committee and others to oppose this, the Taxpayers for Common Sense, and you mentioned war fighters opposed this deal.

Mr. ELLIS. What I had said earlier——

Senator CANTWELL. I didn't know what war fighters you were speaking about or representing.

Mr. ELLIS. Well, earlier in my testimony I mentioned that I thought this was a bad deal for the war fighter, and my understanding is that the lease, monies for the lease, part of a way of making this work is that the funding doesn't come out of the procurement budget for the Air Force, it comes out of their operations and maintenance budget, and so therefore that's going to affect other activities. We're going to have to you can't get something for nothing.

Senator CANTWELL. So I think when you said war fighters oppose this deal, you meant you hoped war fighters would oppose this deal or were you saying that——

Mr. ELLIS. My statement, at least in my oral, at least what I believe I said, was that, at the end, was that we're counting on taxpayers taxpayers are counting on you to stop this juggernaut and that I asked you to ask your colleagues to oppose this, and then earlier in my testimony I said that it was a bad deal for the this deal is more than just Pentagon waste, at least it will have a significant negative impact on servicemen and women on the war fighter.

Senator CANTWELL. At the end you mentioned war fighters, that's why I just wanted to make sure that you were not trying that there was some group that you were representing.

Mr. ELLIS. The war fighter yeah, no I did say the war fighter and taxpayers, yeah, I did, you're absolutely correct, I apologize, and no, I believe that the war fighter, I mean, we look out as an organization we look out for what we think is in our nation's interest, what we think is in the taxpayers' interests and we don't think that this lease the way is currently structured because of where the funding comes from is in the war fighter's interest.

Senator CANTWELL. So that there's no——

Mr. ELLIS. That's my——

Senator CANTWELL. That's your—there's not an organization that you're associated with or members of your organization——

Mr. ELLIS. No.

Senator CANTWELL. Okay. Second question, you mentioned that you though the 70 percent increase in the budget as we moved forward if they went to a procurement would be a tough situation to handle. If you looked at the current procurement proposal as an increase, it would be a 140 percent increase today, so are you more comfortable with that?

Mr. ELLIS. I don't think that delaying tough choices is a very good method to approach this, and I do think that essentially that what we've done here with the budget scoring and other methods that were sort of talked about by Senator Sununu is we've just sort of put of the inevitable, but really only on the books, and so some of these discussions, I do think we have a car wreck going on in our procurement budget in the Air Force, and we're going to have to address that. And we've had it was interesting to hear about the FA–22 coming down because that would be the first time I've ever heard of the costs of the FA–22 coming down, that was mentioned earlier. And I think that a lot of the cost controls and how we're approaching this all have to be addressed, and I would rather do that sooner than wait.

Senator CANTWELL. So since these are tough decisions for all of us, what do you recommend? Do you think we should have a procurement process of 140 percent increase now, cancel other projects that are already on the books, which would you do?

Mr. ELLIS. What I would do is I would go through as much——

Senator CANTWELL. Or just continue to delay the problem?

Mr. ELLIS. No, not delay the problem, no Senator. I believe that we have to address the problem. I think that there are issues and those have to be dealt with, but I think that as the earlier testimony has indicated that this did not seem to become a calamity until just 18 months ago, which seems to me to be a pretty quick ramp-up on this issue. And so I think that this isn't an emergency right now. I think we have to deal with it and we have to move forward and we can't ignore it like the Air Force ignored it for many years. The GAO first started talking about the corrosion issue, for instance, in 1996, and they have avoided that. And I don't think that one wrong decision, which was ignoring the issue, should beget another wrong decision, which is to play smoke and mirror budget tricks to squeeze this in.

Senator CANTWELL. So which of those would you do, because I don't think the problem gets any better next year if you delayed it one more year. And maybe you and I differ but I think a lot's happened since September 11 and I think the Air Force should give us a percentage increase in the sortie demand for those refueling tankers. It's unfortunate that they didn't have that number, but I don't think anything gets better next year and I don't think anything gets better the year after that, so somewhere in that process you have to make a decision. You either have to have a huge procurement increase or you have to cut other things in the budget or accept a lease option. So I'm just trying to understand, of those three options, what does Taxpayers for Common Sense propose?

Mr. ELLIS. Well what I propose is that we go through the processes that we're supposed to and that we really analyze our alternatives and we look at the options. I mean, I listed a couple small ones as sort of a short-term issue of re-engining some of these, the ones that are capable of, I understand not all of them are, I think that we should look at whether we can buy used DC–10s and convert them into KC–10s, which are far more capable than the KC–767 is and also can accommodate more aircraft, and I think that we need to put everything on the table and that's what we should be using this next year for is figuring out what is the best way to do this and what's the best way to meet our aerial refueling needs, not to just buy KC–767s or lease them.

Senator CANTWELL. But in a year the same options will be there.

Mr. ELLIS. But we haven't looked at all the options. I happen to believe that there are a lot of smart people in the Pentagon that need to sit down and really start thinking about what are our needs and what is our future going to be like. What we've heard today is a lot of discussion about how the KC–767 is much better than the KC–135. Absolutely, it is, the only thing that's pretty similar is the fact that it's just got a little more fuel capacity, but other than that it's a far better aircraft. But that's not the discussion. We should be talking about the KC–767 against what our actual aerial refueling need is, and we haven't really done that.

Senator CANTWELL. Actually I did hear that discussion today, but I know my colleague probably has questions too, and maybe if there's a second round, Mr. Chairman.

The CHAIRMAN. Senator Brownback.

Senator BROWNBACK. Thanks, Mr. Chairman. General Sams, you had stated in your testimony that you gave the United States Government the best deal that you've given to any commercial enterprise, is that correct?

General SAMS. Yes, sir, that's correct.

Senator BROWNBACK. You've also stated that if you do give a commercial enterprise a better deal in the next two years, you'll come back and rebate the U.S. Government on that, is that correct?

General SAMS. Yes, sir, that's correct?

Senator BROWNBACK. And that's until the end of the contract with the U.S. Government, is that correct?

General SAMS. Yes, sir.

Senator BROWNBACK. Okay. Now looking at this from a leasing arrangement, does that also include, that is what you're talking about, as a leasing arrangement this is the best lease that you've offered to any commercial enterprise?

General SAMS. Actually, Senator, Boeing will not be leasing the airplanes as we discussed a little bit earlier. Boeing will do what Boeing traditionally does best and that's produce airplanes and then we have offered to sell those airplanes to the Air Force or to a leasing company. The Air Force asked us to facilitate leasing because that was the legislation that was approved. So the sale of that aircraft for the purposes of the 767 tanker would be the same price in either direction, and in this case would be to a leasing company which has been established as a nonprofit trust.

Senator BROWNBACK. but that price is still, it's the best price that you're offering to any commercial entity and will be over the next two years, is that correct?

General SAMS. Actually it's the best price that we've offered over the last 17 years, and we will in the future sell no aircraft at a lesser price for the total future of the program.

Senator BROWNBACK. Dr. Nelson, there was a were you here for the earlier panel?

Dr. NELSON. Yes, I was.

Senator BROWNBACK. There was testimony by CRS that was saying we're paying substantially more than we should as a lease proposal on this. Did you hear that?

Dr. NELSON. Yes, I did.

Senator BROWNBACK. Have you had a chance to look at any of their analysis and compare it to yours on a leasing arrangement?

Dr. NELSON. We were not tasked to look at the lease, Senator. We looked only at the direct purchase price.

Senator BROWNBACK. All right. General Sams, there's been a— you've had an ongoing negotiation with the Pentagon on the price of this product for several years now, haven't you?

General SAMS. Yes, sir, for ongoing 24 months.

Senator BROWNBACK. And I believe that even they've been able to get you down as I see in the reporting about $2 billion from your original asking price?

General SAMS. Yes, sir. Originally as negotiations started, and they are negotiations, we had offered a price in the neighborhood of $150 million, knowing that we would negotiate a price.

Senator BROWNBACK. Thank you very much, Mr. Chairman, for hosting the panel. Thank you all for being here.

The CHAIRMAN. Do you have further questions?

Senator CANTWELL. Thank you, Mr. Chairman, if I could. I was just going to ask Dr. Nelson, in your report I know you didn't deal with the lease, but how do you deal with the uncertainty that the Air Force has to own up to and adhere to in their planning models of dealing with how change is occurring and how they plan for the future?

Dr. NELSON. Well we were only tasked to look at this specific element of the analysis. If there were an AOA, I think that it would be addressed in that context with regard to force-level planning, total life cycle costs, and other issues.

Senator CANTWELL. And do you think that the Japanese and Italians are extremely wealthy countries in the sense of they've obviously paid a purchase price for these planes already which is well above the mark that you have suggested. What do you think is the reason for that?

Dr. NELSON. Well, all it would be helpful to know all the terms of the sale. I would assume that the Japanese and the Italians are buying more, much more than just the airplanes. They buy spares, they buy training, there may be some work done in the buyer country which introduces other inefficiencies in pricing, the detailed physical characteristics might be different. We can't comment any further than that there are many issues that must be looked at in more detail.

Senator CANTWELL. And doesn't that kind of sum up what this afternoon has been about, that everybody has used different assumptions and different models and different comparisons and different maintenance costs and different time frames and different issues?

Dr. NELSON. And different agendas.

[Laughter.]

Senator CANTWELL. Well certainly I think it's safe to say that the chairman has had his agenda today heard, and he's been so kind to let us keep you here for a second round of questioning, which I very much appreciate, but I think these are important issues as it relates to a 1996 report basically saying we have a severe problem hitting us right in the face, and now we hear from the Air Force today that they also have to plan for a different level of activity than was anticipated two years ago. And so somehow that isn't calculated into the report.

Dr. NELSON. Right. There are many issues that need to be considered in coming to a decision about this, and clearly the need is paramount, the delivery schedule, and when the airplanes show up, and the cost to the taxpayer, all of these have to be considered.

Senator CANTWELL. Thank you.

The CHAIRMAN. I want to thank you, Senator Cantwell, thank the witnesses, thank you for your patience today, and we appreciate your testimony. This hearing is adjourned.

[Whereupon, at 5:28 p.m., the hearing was adjourned.]

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